Before the
V.I. Public Services Commission

IN RE:

INVESTIGATION OF RATES OF VIRGIN ISLANDS TELEPHONE COMPANY (d/b/a INNOVATIVE COMMUNICATIONS)	)	**PSC DOCKET No. 578**

FINDING OF FACTS

By: David Marshall Nissman
Hearing Examiner

After reviewing the evidence and argument presented by the participants in this proceeding, the Hearing Examiner finds that:

1. Investment in the United States Virgin Islands carries an attendant risk not experienced in comparable investment on the mainland and the estimated cost of capital to VITELCO upon a sale of the company is not less than 11.5%;

2. A rate-of-return must be authorized by the Virgin Islands Public Service Commission prior to use by a regulated utility and the authorized rate of return must be equal to or greater than the cost of capital to the Company;

3. A rate-of-return of 11.5% is currently authorized by the virgin Islands Public Service Commission for use by VITELCO and the constitutional standard announced by the Supreme Court requires that the rate of return VITELCO is entitled to is not less than 11.5%.

4. VITELCO has used 11.5% as its permitted rate-of-return in calculating its revenue requirement.

5. VITELCO effectively earned a return of 9.28% for the 2008 test year.

6. VITELCO has failed to make the investments in the Virgin Islands telephone system that it has promised the PSC and the EDC.

7. VITELCO is not providing adequate telephone service to the Virgin Islands and until, VITELCO invests in a new network, telephone services will continue to be deficient;

8. VITELCO will not be permitted to use its current EDC tax benefit as a method of increasing its rate of return;

9. The 1992 agreement on depreciation schedules for VITELCO is in effect until VITELCO is placed on written notice that those schedules will not be used again;

10. The 1992 depreciation schedules confer too great a depreciation benefit on VITELCO. Based on the facts and the case law a depreciation system that allows a telphone company to depreciate 200% of its costs is inappropriate and VITELCO is hereby placed on notice that the 1992 schedules will not be used again in any subsequent rate investigations;

11. Inter-corporate advisory fees present a great opportunity for the ratepayers to be abused and the previous system and process employed by VITELCO and its parent ICC is hereby prohibited;

12. In lieu of inter-corporate advisory fees, VITELCO will have to pay for corporate overhead which includes professional fees. For purposes of this proceeding, VITELCO will be permitted a maximum of $814,312.00 for corporate professional expenses.

13. VITELCO's ratebase is currently $60, 235, 716.00.

14. Based on the foregoing regarding VITELCO's rate base and operating expenses, we find that VITELCO's current rates generate a rate of return of 9.28%. This rate of return is below the Company's currently authorized rate of return of 11.5% and is less than VITELCO's current cost of capital, which we find to be in excess of 11.5%. Under the circumstances, we find no basis to conclude that VITELCO is overearning and thus do not accept the Commission's Technical Consultant's recommendation that VITELCO's current rates be reduced.

15. However, these findings should not be construed as authorization for VITELCO to increase rates after this proceeding has concluded. The determinations by the Hearing Examiner concerning VITELCO's cost of capital are complicated by the Company's financial situation and the current sale process. After that sale process has concluded, the Commission will be able to determine more precisely VITELCO's cost of capital, since it will know the new company's capital structure and cost of debt -- information that is not available to the Hearing Examiner.

Should VITELCO seek to increase rates before the next earnings investigation, the Commission should carefully scrutinize any proposed rate increase and ensure that any new rates: (i) do not result in VITELCO earning in excess of its cost of capital; (ii) reflect new depreciation rates consistent with this Recommended Order; and (iii) are commensuate with the quality of service being provided by VITELCO.

ORDERED that these findings be presented to the Public Service Commission with the Hearing Examiner's Opinion.

Entered this 1st day of December, 2008.

David Marshall Nissman
Hearing Examiner

Before the
V.I. Public Services Commission

IN RE:

INVESTIGATION OF RATES OF VIRGIN ISLANDS TELEPHONE COMPANY (d/b/a INNOVATIVE COMMUNICATIONS)	)	**PSC DOCKET No. 578**

MEMORANDUM OPINION AND ORDER

Opinion Dated: _____ **Adopted:** _____

By: David Marshall Nissman
Hearing Examiner

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I. INTRODUCTION

Under Virgin Islands Law, the PSC must conduct a Rate Investigation of each utility at least once every five years. On April 20, 2001 the Legislature of the United States Virgin Islands enacted Act 6402 (the "Act") directing the Public Service Commission ("PSC") to conduct a biennial financial review of public utility organizations licensed to operate in the US Virgin Islands.[1] Act 6402 reaffirmed the responsibility entrusted to the PSC for ensuring a) the interests of the Virgin Islands' public are preserved and b) the statutory requirements set forth by the Legislature are complied with by all utilities that are subject to the authority of the PSC. Given the great expense and the time consuming nature of such investigations, the Statute was later amended to allow the Commission to conduct such rate investigations every five years. The last time the PSC conducted a rate investigation of VITELCO was in 2003 and the results were finalized in 2004. The PSC was required to begin such an investigation in 2008 and issued an order to commence the current Rate Investigation, known as Docket #578.

In these matters the Public Service Commission issues an order to commence the investigation and then selects and appoints a Hearing Examiner.[2] The Hearing Examiner serves in the role of an Administrative Law Judge. The Hearing Examiner sets public hearings, takes

[1] Act 6402 specifically amended the V.I. Code to provide that "Commencing July 30, 2001, the Commission shall conduct rate investigations of all regulated utilities biennially and hold formal hearings as required under subsection (a) of this section". V.I.Code Ann. *tit. 30 §20(b).*

[2] The Commission originally appointed Judge Thomas Moore, retired United States District Court Judge to conduct the hearing. The appointment was dated August 21, 2008. The attorneys for the PSC and VITELCO then entered into a proposed agreement as to the scope of the issues to be litigated in this proceeding. Judge Moore's participation in our constitutional convention caused him to withdraw from the proceeding and the Commission then appointed this Hearing Examiner. This Hearing Examiner chose to use proposed scope of issues order that the parties had worked on with the addition one other issues and that involved the adequacy of service issue discussed, supra. The proposed order included the change of control issues surrounding the anticipated sale of VITELCO to be conducted by the Bankruptcy Trustee on or about December 19, 2008. A discussion of the issues litigated in this rate investigation is contained in Section III of this Opinion.

testimony and reviews documentary evidence, rules on issues of law and procedure and then issues an opinion and order that is similar to judicial opinions and orders. Just as a Federal Magistrate Judge makes a ruling known as a Report and Recommendation for consideration by the United States District Judge, the Hearing Examiner issues its opinion and order to the Public Service Commission who then has the authority to adopt, reject or modify the order issued by the Hearing Examiner. For purposes of this opinion it is important to explain that the parties are VITELCO and the PSC which is represented by staff attorneys. The PSC Commission sits as the ultimate trier of fact. References to PSC positions taken during the investigation refer to staff attorneys and not the Commission.

During the last VITELCO Rate Investigation, known by its Docket #532, Frederick Watts was appointed Hearing Examiner by the Commission in 2001 and he concluded his investigation in 2003 with what all parties in this case view as a highly scholarly and well thought out opinion. We will refer to his opinion throughout this one and to avoid confusion we will refer to him for purposes of this opinion as Judge Watts. With his permission we have borrowed from his opinion and refer to it throughout this document.

While Judge Watts was a pioneer in that he was required not only to conduct an investigation but to create a structure in which to do so as his was the first investigation to follow the 2001 statute, we find that we have been asked to operate under a highly compressed schedule due to the unique circumstances created by the bankruptcy proceeding of VITELCO's parent company, referred to here as ICC or Innovative. The Bankruptcy Judge, through the Bankruptcy Trustee, has set a December date for the auction of certain ICC assets which includes VITELCO and the PSC is operating with respect and deference to the Bankruptcy Court's schedule. In this proceeding we also found that the Bankruptcy Trustee was cooperative and respectful to the PSC in this proceeding and it was encouraging for the Hearing Examiner to view this mutual respect which sadly had not been present during the early days of the bankruptcy case through no fault of the Bankruptcy Court or the Trustee. The Public will no doubt agree that government acts best when it acts in a coordinated respectful manner which increases the likelihood that both the

public and individual interests will be balanced and protected. It is under this framework that we have operated in conducting these hearings even though the compressed schedule has caused all parties, witnesses, attorneys and our court reporter to have to work long hours to complete the mission. Where Judge Watts had two years to complete his investigation, we have had one month.

Docket No. 578 was initiated for the expressed purpose of conducting the rate investigation of Innovative Telephone Company prescribed by Act 6402, codified as Title 30 Virgin Islands Code Section 23. The PSC has authority to appoint a Hearing Examiner pursuant to 30 VIC 18 which empowers the PSC to appoint agents who "shall have every power whatsoever granted in this chapter to the Commission, except the power to issue any order for which a hearing is required." The Commission can limit the authority of its Hearing Examiner but in this case chose not to. The Hearing Examiner has thus viewed all parts of Title 30 VIC 23 as appropriate subjects for this rate investigation. Accordingly, the Hearing Examiner notified the parties on October 30, 2008, in a pretrial conference, that the adequacy of service, or the lack thereof, would be one of these issues to be adjudicated during the proceedings.

During the pretrial conferences held on October 30, 2008 and November 4, 2008, the Hearing Officer listened to the positions of Counsel for both the PSC and VITELCO and issued rulings on the procedural structure to be followed. After consultation with the Parties, the Hearing Examiner ordered that a third day of public hearings would be scheduled so that ratepayers on all three islands could attend and offer testimony. Public hearings were held on November 5 (St. Croix), November 6 (St. John) and November 7 (St. Thomas). Due to the compressed nature of the proceedings, the Hearing Examiner permitted the parties to supplement the record with additional affidavits, documents, and arguments and directed that such supplemental documents would be entered into the public record so that the public would have access to the complete record of this case.

II. REGULATORY FRAMEWORK

Public utilities granted authority by the Virgin Islands Public Service Commission to provide services in the Virgin Islands are obligated – under V.I. Code Ann. *tit. 30 §2* – to ensure that rates and charges for services offered to the public are just and reasonable.[3] Under Virgin Islands law, VITELCO's rates are established at "just and reasonable" levels that provide the Company with recovery of its costs and a reasonable opportunity to earn a fair return on its invested capital. *See* V.I. Code Ann. Tit. 30, § 23.

It is important for the public and all interested parties to understand that "just and reasonable" standard is constitutionally mandated and the Hearing Examiner and the Commission is required to follow the constitutional standard that was announced by the United States Supreme Court in two cases of *Bluefield Water Works & Improvement Company v. Public Services Commission of West Virginia,* 262 U.S. 679 (1923) (hereafter referred to simply as *Bluefield*) and *Federal Power Commission v. Hope Natural Gas Co.,*320 U.S. 591 (1944) (referred to as *Hope*). The Supreme Court essentially held that where a business dedicates its assets to public service it would be an unconstitutional taking by the government to deny the company a reasonable rate of return. Reasonable rate of return is strongly tied to the cost of capital. The *Bluefield* case held that:

> The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money for the proper discharge of its public duties. *Id* at 693.

[3] V.I. Code Ann. *tit. 30 §2* states "...every public utility doing business within the United States Virgin Islands is required to furnish service and facilities reasonably safe and adequate and in all respects just and reasonable. The charge made by any such public utility for any facility or services furnished, or rendered, or to be furnished, or rendered, shall be reasonable, just and nondiscriminatory. Every unjust or unreasonable or discriminatory charge for such facility or service is prohibited and is hereby declared unlawful. Every public utility is hereby required to obey the lawful orders of the Commission."

The return on investment (expressed as an allowable percentage) must be 1] fair to the public interest; 2] be consistent with other investments of similar risk; and 3] must be sufficient to assure confidence in the financial integrity of the enterprise (in this case the telephone company).

The *Hope* case held that:

> [I]t is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risk. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital. *Hope* at 603.

Our statute provides that:

> In exercising its authority to prescribe just and reasonable rates, the Commission shall provide a return of not less than six (6) nor more than eight (8) percent on the net investment in the property prudently acquired for and devoted to the public use, unless the Commission makes a special finding that a different return is imperative, so as to be fair to the consumer interest, and to be fair to the investor interest by providing a return commensurate with returns in other enterprises having corresponding risks, and which will assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[4]

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[4] V.I. Code Ann., Title 30, § 23(b).

In this case the PSC and VITELCO have stipulated that a return in excess of eight percent is imperative. In addition, all of the evidence adduced during the hearing conclusively established that the cost of capital is in excess of eight percent. Accordingly, the Hearing Examiner makes the special finding that a return in excess of eight percent is imperative. In doing so, it must be understood that in making such a finding we are directed by the standard mandated by the Constitution as announced by the Supreme Court in the *Bluefield* and *Hope* cases discussed *infra*. Given those cases and the evidence adduced during the public hearing the Hearing Examiner has no choice but to so conclude and we therefore make that special finding required by our Virgin Islands statute.

In assessing whether VITELCO's current rates are "just and reasonable," the Hearing Examiner must determine VITELCO's "revenue requirement" -- the amount of revenue to which the Company is entitled in providing telephone service to the public. *See generally* P. Huber, M. Kellogg, & J. Thorne, *Federal Telecommunications Law* § 2.2.3 (2d ed. 1999).

A regulated utility's revenue requirement is determined by first selecting an appropriate test year. The test year measures a company's operating experience during a twelve-month period and is the basis for determining representative levels of revenues, expenses, and rate base and capital structure. The test year is one of the fundamental concepts upon which a determination as to a regulated utility's revenue requirement and the reasonableness of its rates is based. *See, e.g., South Central Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n*, 744 F.2d 1107, 1110 (5th Cir. 1984) ("In determining a rate structure that will adequately meet a utility's prospective revenue requirements, a regulatory commission makes predictions based on the utility's revenues, expenses, and investments in some selected previous year, called the 'test year'").

In this proceeding, both VITELCO and the Commission's Technical Consultants selected a test year based on the twelve months of calendar year 2008. *See* Revised Direct Testimony of Donald E. Parrish, at 6; Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 10 & Schedules 1-3. The test year revenues and expenses were developed based on actual operating results for the first seven months of 2008 and were projected for the remainder

of the test year using annualization factors; these results also were "normalized" for extraordinary revenues and expenses incurred in the test year and adjusted to reflect known and measurable changes in VITELCO's revenues and expenses. *See* Revised Direct Testimony of Donald E. Parrish, at 6. For example, both VITELCO and the Commission's Technical Consultants adjusted the test year results by reducing VITELCO's revenues to reflect reduced universal service funding that the Company is expected to receive on a going-forward basis. *See* Exhibit DEP-5.

The Hearing Examiner concludes that a test year based on the twelve-month period for calendar year 2008 is appropriate for determining the reasonableness of VITELCO's rates; it is a time period sufficiently close to the period of time for which actual data is available and reasonably represents VITELCO's cost of providing telephone service during the period when VITELCO's rates will be in effect. The Hearing Examiner also concludes that the adjustments made to test year data for known and measurable changes is appropriate and consistent with ratemaking regulation. *See, e.g., South Central Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n*, 744 F.2d at 1110 (noting that a regulated utility's "cost of service for the test year is adjusted for any extraordinary change expected to occur in the upcoming year"); *Annual 1987 Access Tariff Filings*, 2 FCC Rcd 290, 287 (1986) (approving tariff filings "based on rate of return analysis using actual operating results for the rate period and forecasts based on the costs and demand forecasts ... adjusted for known changes"); *see also* 47 C.F.R. § 76.922(h)(i)(4), (5) (requiring that the return and expense components of rate base calculations for cable operators be "adjusted for known and measurable changes occurring between the end of the test year and the effective date of the rate").

III. SCOPE OF PROCEEDING AND ISSUES OF INTEREST

As indicated in earlier sections of this Opinion, this rate investigation proceeded under a very compressed schedule due to the unique proceedings surrounded the problems associated with VITELCO's parent, ICC, which is currently in bankruptcy proceedings. Nonetheless, working on a daily schedule that included nights and weekends, the attorneys for both sides and the Hearing Examiner conducted a very complete investigation which included three days for public testimony, one on each of the three major islands in the Territory. The parties worked very hard to narrow the issues before, during and after the public hearings and the Hearing Examiner finds that this extra effort on behalf of the attorneys significantly affected our ability to conclude this important investigation in such a short time frame. A short concise statement of relevant issues is contained in the bullet points below. The framework and definitional statements were borrowed from Judge Watts' Opinion in Docket #532 and edited by the Hearing Examiner in Docket #578, the instant case.

Prior to the appointment of this Hearing Examiner the parties agreed to a list of issues to be litigated in this case and the parties drafted a proposed order entitled "Notice of Scope and Schedule." The issues of interest in the order are reprinted below:

> The list of issues to be addressed includes, but are not limited to, the transfer of control of VITELCO, revenue requirements, capital structure, transfer of control and rate of return. It is anticipated that the capital investment needs and the five-year plan will be subjects that the parties are likely to agree on.[5]

The Hearing Examiner adopted the Order prepared by the attorneys for the PSC and VITELCO but, after reviewing Title 30 Virgin Islands Code, Section 20, added one more, the

[5] While the parties did an exceptional job narrowing the issues, including an agreement on the rate base, discussed, supra, they were not able to agree on the capital investment needs and the five year plan and this issue is discussed in Section XII of the Opinion, titled Change of Control Issues.

adequacy, or lack thereof, of VITELCO's telephone services. The Hearing Examiner notified the parties of this decision at a pretrial telephone conference on October 30, 2008.

One key issue, not normally present in a rate investigation (that added a great level of complexity to this case) concerns an analysis of change of control issues that will follow the sale of VITELCO by the Bankruptcy Court.

Below are the bullet points originally developed by Judge Watts and edited for use in this hearing.

- **rate base** – verify that the net, or depreciated, value of all tangible and intangible property, used to provide regulated telecommunications services reflected in the company's books and records is consistent with reporting requirements of territorial and federal agencies. In this case the parties had narrow differences that actuality narrowed further during this investigation. Based on all of the evidence, the Hearing Examiner concludes that the rate base is $60, 235,716.00.
- **rate-of-return**– propose an appropriate return (expressed as a percentage of the depreciated value of all tangible and intangible property) that is deemed to be fair to investors and comports with the standards set forth in Virgin Islands statute;
- **cost-of-capital** – identify the rate (expressed as a percentage) that VITELCO must expect to receive to maintain its credit rating, to pay a return to investors, and to attract investment in amounts adequate to meet future needs;
- **over or under earning analysis** which includes a discussion of many of the bullet points listed below;
- **appropriate depreciation schedule** – is VITELCO using appropriate depreciation rates fair to both the company and the ratepayers;
- **special tax benefits** – evaluate the current method of recognizing financial benefits provided by the Economic Development Commission and its effect on the company's revenue requirements;
- **affiliate transactions** – verify that services performed by the parent company for the benefit of VITELCO are properly charged and recognized in the company's income statement and are not abusive to the ratepayers or alternatively develop a formulaic system that provides appropriate limitations;
- **marketing expenses** – analyze whether the company will be allowed claim an expense passed on the ratepayers for marketing;
- **adequacy of service** – analyze whether VITELCO service is adequate and, if it is not, propose appropriate measures to be implemented to improve customer service;
- **change of control** – based on all of the factual information analyzed in this rate investigation (and in analyzing the prior history of VITELCO as evidenced by PRIOR PSC actions) identify and analyze issues that must be resolved at a subsequent change of control hearing.

IV. RATE OF RETURN AND COST OF CAPITAL

Under Virgin Islands law, the Commission regulates the rates VITELCO may charge for its services. As part of that task, the Commission sets the rate of return on capital that VITELCO may use in setting its rates, which are calculated so that the carrier's projected revenues will cover projected operating expenses plus the authorized return on capital. Because of the inherent difficulty in making these projections, a carrier's actual return "will virtually never" match precisely the carrier's authorized return, and some variation in the actual and authorized returns of a carrier is to be expected. *See AT&T v. FCC,* 836 F.2d 1386, 1388 (D.C. Cir. 1988). However, if a carrier's rates consistently generate a return in excess of its authorized return, the carrier is said to be "overearning," and its rates may be reduced. *See New England Tel. & Tel. Co. v. FCC*, 826 F.2d 1101, 1107-08 (D.C. Cir. 1987), *cert. denied*, 490 U.S. 1039 (1989) (carrier required to lower rates when its actual return exceeded its authorized return).

The cost of capital to VITELCO must be determined in order to authorize a "fair and reasonable" rate of return. The responsibility for determining the cost of capital for ratebase regulated utilities lies with the Commission, which makes this determination based on a combination of the utility's cost of debt and cost of equity as well as the utility's capital structure. In a typical rate investigation, the utility's capital structure and cost of debt are known variables, and the cost of equity (which is never actually observed because it represents the future expectations of investors) is estimated using various techniques. Here, as explained in greater detail below, VITELCO does not have an actual capital structure, and the Commission does not know what VITELCO's cost of debt is going to be. 11/5/2008 Transcript at 153-55.

Determining VITELCO's cost of capital is further complicated by the questionable behavior in which its prior management was engaged, which will cause an increase in the capital costs of the Company. In particular, due to the abysmal record of the former management of the Company which ignored the needs of the ratepayers, VITELCO has: (i) been losing customers due to the inadequacy of the quality, reliability and availability of telephone services; (ii) a dearth of modern products to offer to a waiting populace; and (iii) a network infrastructure that is

in poor condition. These factors, in addition to the company's relatively small size and the additional risk associated with investing in the United States Virgin Islands, mean that the cost of capital to VITELCO in the future will be higher than any comparative group of telephone companies.

Finally, this proceeding is taking place against the backdrop of the financial meltdown the country is currently undergoing, which decreases the availability of debt financing and thus increases the cost of debt. VITELCO Expert Witness David Blessing testified that he used an acceptable industry standard model to compute VITELCO's estimated cost of capital but in his written submission opined "there are a number of reasons to believe that an estimated weighted average cost of capital for VITELCO of 13.05% is too low." The Hearing Examiner, in conjunction with the testimony of Blessing, Byron Smyl and PSC Expert Witness David Parcell, takes judicial notice that the U.S. and world economies are continuing to decline and difficult economic conditions are certain to increase. Debt financing is becoming increasingly more expensive and scarce. Equity investors recognize that they are in a buyer's market and look for more significant returns than a utility company is likely to generate.

a. Debt: Equity Ratio

The cost of equity capital is always higher than the cost of debt financing due to the risk return ratio present in all commercial financial investment decisions. Equity investors assume a larger risk than lenders and, as a consequence, equity investors demand the potential of a higher return before they will place their capital at risk. Because the capital needs of a company encompass elements of both equity and debt financing, the debt-equity relationship is an important mathematical equation that is used in fixing the just and reasonable rate of return that this tribunal is constitutionally required to employ. In addition, while debt is less expensive than equity financing, increasing the proportion of debt in the capital structure will increase both the utility's cost of debt and the cost of equity because of the positive effect of increased leverage on risk.

Normally, rate investigations analyze the utility's actual capital structure to determine the cost of capital. In contrast to the record relied on in earlier rate investigations, the Parties and the Hearing Examiner have been required to make estimations and projections based on the expert

evidence adduced during the public hearings because we cannot use VITELCO's current financial condition in that VITELCO and Innovative have defaulted on their financial responsibility to both lenders and investors which is a critical issue that led to Innovative's bankruptcy.

Effectively, VITELCO does not have a capital structure at the present time. Although both common stock (pledged as security but titled to the bankrupt Innovative Communications Corporation) and preferred stock (subject to pending litigation in the Southern District of New York) remain outstanding, the company is presently being sold by the Chapter 11 Trustee of Innovative and will have an entirely new capital structure following the sale. The capital structure post sale is unknown at this time, but the Commission's Technical Consultants have suggested that an appropriate model would be to assume that a new owner will have a capital structure of 50% capital investment and 50% debt financing. In other words, if a new owner pays $200 million for VITELCO, the experts' model assumes that $100 million is raised by selling equity and the other $100 million is raised through loans. We will use the 50/50 equity/debt structure for purposes of our analysis.[6]

b. Cost-of-Debt

In 2004, in Docket #532 the PSC fixed the allowable rate of return for VITELCO at 11.5%.[7] The evidence summarized by Judge Watts in Docket #532 indicated that the PSC's technical consultants estimated that the embedded cost of long-term debt to VITELCO was

[6] While we will use this hypothetical capital structure, it is no means conclusive. It is our view that a new investor will attempt to get as much financing as is possible with as little investment as is necessary. Thus, it is conceivable that a buyer might bring an 80/20 financing/equity structure in the company, but doing so may increase the firm's cost of capital (even though debt is generally cheaper than equity) because of the risk associated with such a high degree of leverage. The Commission should continually monitor VITELCO's capital structure after the sale has been completed, both for purposes of ensuring the financial integrity of the Company and for conducting future rate investigations (and it should be noted that the PSC does not have to wait five years but can order a new rate investigation at anytime).

[7] Hearing Examiner Watts, after a careful and thoughtful analysis fixed the rate of return at 10.62% but the Commission did not accept this aspect of his decision and adopted a rate of return of 11.5% instead.

5.67%.[8] VITELCO's position was that the forward-looking cost of long-term debt to Innovative was 7.70%.[9] The evidence produced at these hearings indicates that VITELCO's existing long-term debt, which is largely through the RTFC and RUS loans, is in fact lower than the estimates of even the PSC's consultants. Mr. Parcell's testimony indicated that the actual cost of debt was about 4.41% for VITELCO. However, VITELCO's actual cost of long-term debt is not indicative of the cost of debt that the Company will incur after the sale since the interest rates that VITELCO currently enjoys are not available to potential bidders. Affidavit of Byron Smyl ¶¶ 4-5.

There is no doubt that the future cost of debt is likely to be well in excess of both of these 2004 figures. The PSC's consultant made his debt estimations based on VITELCO's ability to secure at least a BBB rating in the capital markets.[10] I find that there is little chance that VITELCO, on its own, could achieve a BBB rating. It is possible that a national telephone company that acquired VITELCO could use its own resources and credit rating to achieve a BBB rating but, on this record, it would be entirely speculative to create a scenario that the evidence in this case would support. In any event, the current yield on BBB corporate bonds is 9.39%. Rebuttal Testimony of David Blessing, at 25.

The Hearing Examiner accepts the information contained in the Affidavit of Byron Smyl. Mr. Smyl is the Bankruptcy Trustee's representative in this Rate Investigation. Mr. Smyl has independent experience in the telecom industry. He both testified as a witness and participated throughout the entire proceedings by both attending the testimony and in answering our continued questions as they came up during this investigation. We find that Mr. Smyl is a credible, competent witness with the necessary expertise to furnish the information the Hearing Examiner asked for on this issue. Mr. Smyl in his Affidavit indicated that "the Rural Telephone Finance Cooperative ("RTFC") has agreed to make subsidized debt available to potential

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[8] Docket #532 Technical Consultant Report TC Exhibit 6, p.1of2

[9] Docket #532 Billingsley Pre-Filed Testimony, at p. 47, lines 14-15.

[10] A "BBB" or "triple B" is a proprietary term employed by Standard & Poors in its review of bond and debt issuance.

bidders. Although the specific interest rate has not been set, the initial indication from the RTFC is that the rate is likely to range between 9.5%-10.5%, which is well below current market levels as presented later in his Affidavit." Mr. Smyl's affidavit indicates that the present cost of unsubsidized debt in the telecom industry is running in excess of 15%. Indeed VITELCO Expert Witness David Blessing testified in his written submission that "in VITELCO's case, the current cost of debt would reflect the financial realities faced by VITELCO today, which would mean a cost in excess of 17.96%." Direct Testimony of David Blessing, at 25.

Accordingly, we find that current conditions suggest that the cost of debt financing will not likely be less than 10%,[11] which would represent a significant increase in VITELCO's cost of capital since the last rate investigation.

c. Cost-of-Equity

The approach to calculating the cost-of-equity capital is prospective. On that witnesses from both sides agree. Since VITELCO is not a publicly traded company, any accurate determination of the cost-of-equity capital is based on models and comparisons. The Hearing Examiner recognized that using this approach embodied the standards used in other rate investigations but did not want to be bound entirely by evidence that appeared both academic and speculative. The Hearing Examiner asked to have input from the Bankruptcy Trustee's representatives because we could then determine what the real cost of equity capital is at the current time to people who are actually trying to raise money to buy this company. Once again, Mr. Smyl provided helpful information in this regard although Mr. Smyl's information also relies on general data and not the actual cost to prospective bidders.[12] Thus, all of the witnesses found it necessary to postulate, to the degree possible, what the forward-looking cost might be.

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[11] The mean point of the RFTC estimate is 10%. Even assuming a subsidized rate of 9.5%, there is no indication that the RFTC will agree to finance everything a new owner needs, thus leaving some percentage of debt financing at a much higher, unsubsidized rate.

[12] In fairness to the Bankruptcy sale process, this information may be highly confidential and difficult to acquire, assemble and release.

Judge Watts in his Opinion in Docket #532 found the cost of equity capital to be 15% and for the reasons outlined below, the Hearing Examiner in this case and at this time finds that the current cost of equity capital is not less than 15%.[13] VITELCO Expert David Blessing estimated the cost of equity capital to be in excess of 15%. PSC Expert David Parcell estimated the cost of equity capital to be 12.1%. Bankruptcy Trustee representative Adam Dunayer[14] opined that world wide economic conditions made it very difficult for qualified buyers to raise the necessary capital to purchase the company for the price required to satisfy creditors,[15] which, according to Mr. Dunayer's testimony includes $20 million to go to the employees' pension fund.[16] Finally,

[13] The technical consultant in Docket #532 estimated that the forward-looking "net" cost of equity capital to Innovative to be 13.90%. Hearing Examiner Watts then added a premium of 1.1% to reflect the additional cost of equity capital necessary before prudent individuals made equity investments in the Virgin Islands. This Hearing Examiner in Docket #578 finds based on the Hearing Examiner's experience as a former CEO of an international lending and development company that the capital markets have historically charged premiums to invest in the U.S. Virgin Islands. While the Hearing Examiner is critical of this long standing practice, this is the reality of market driven conditions as they affect us in this community.

[14] In his written rebuttal testimony Mr. Dunayer explained that: ""By order entered on October 7, 2008, the District Court for the Virgin Islands, Division of St. Thomas and St. John, Bankruptcy Division (the "Bankruptcy Court"), the Honorable Judith K. Fitzgerald presiding, authorized Stan Springel, chapter 11 trustee ("Trustee") of the bankruptcy estate of ICC, to employ Houlihan Lokey as a financial advisor to the Trustee for the purpose of selling the common stock of ICC's operating subsidiaries. I am the principal professional at Houlihan Lokey providing advice to the Trustee in connection with the sale process for ICC's primary operating subsidiaries...."

[15] Dunayer testified that an offer of less than $185 million would likely not be approved by the Bankruptcy Court.

[16] It is inconceivable that the misappropriation of the $20 million from the employees' pension fund, allegedly by prior management, will not be subject of a separate criminal investigation and the Hearing Examiner recommends that VITELCO, the PSC, and the Trustee coordinate their efforts to cooperate with any such investigations that may be under way. On this point and many others where misappropriation and illegal diversion of assets is being claimed, there can be complicated issues concerning restitution. The criminal justice system works better when the victims can agree and present coordinated positions on restitution so that a Federal or Superior Court judge will not have to listen to weeks of conflicted testimony followed by endless appeals on who is entitled to any proceeds recovered in any successful criminal case.

the Hearing Examiner directed Attorney Ross to have Mr. Smyl present a supplemental affidavit specific to the issue of the cost of equity capital. Mr. Smyl's supplemental affidavit includes the following paragraph:

> To obtain representative equity returns that are currently being required in the market place, I spoke with professionals from Houlihan Lokey Howard and Zukin, ("HLHZ"), the investment bankers hired by the Chapter 11 Trustee, to attempt to get published data on what returns Private Equity ("PE") firms are requiring on their equity investments. I was informed that there is practically no published data on the returns of PE firms, hence the reference to "Private" equity. However, over years of working with the representative PE firms that are interested in becoming bidders for the Group 1 assets, including VITELCO, the professionals from HLHZ have developed enough institutional knowledge regarding the returns that these PE firms require. The professionals from HLHZ provided a range of the required cost of equity for the PE firms between 25%-30%.

We conclude from all of the evidence that the cost of equity capital is in excess of 15%.

d. Conclusion: Cost-of-Capital

As we have indicated, it is impossible to determine VITELCO's weighted cost of capital because we have no idea what percentage of the Bankruptcy sale will be attributed to debt financing and what percentage will come from equity investments and we do not know for certain what VITELCO's cost of debt will be under new ownership. Nonetheless, we find that the cost of debt available to VITELCO will not be less than 10% and the cost of equity will exceed 15%. Because VITELCO is not seeking a rate increase, the Hearing Examiner need not make a definitive finding on the exact cost of capital if the testimony establishes that the cost of capital is in excess of 11.5%, which is VITELCO's current authorized rate of return. Since the Commission found five years ago in Docket #532 that VITELCO was entitled to a return of 11.5%, the risk associated with an investment in VITELCO (and thus the Company's cost of capital) has only increased, as explained previously. We find based on all of the evidence using a preponderance of the evidence standard that VITELCO's cost of capital is in excess of 11.5%.

V. REQUIRED SERVICE IMPROVEMENTS

The earlier rate investigations focused solely on financial issues. Our statute provides, however, that the PSC through its agent, the Hearing Examiner, has broader authority. Title 30, Virgin Islands Code, Section 20 provides:

> **(a)** Upon its own initiative or upon reasonable complaint made against any public utility that any of the rates, tolls, charges, or schedules, or services, or time and conditions of payment, or any joint rate or rates, schedules, *or **services** are in any respect unreasonable or unjustly discriminatory, **or any service** in connection therewith, is in any respect **unreasonable, insufficient, or unjustly discriminatory, or that any service is inadequate or cannot be obtained***, or any billing for service inaccurate or erroneous the Commission may, in its discretion, proceed, with or without notice, to make such investigation as it may deem necessary or convenient. But no order affecting said rates, tolls, charges, schedules, regulations, or act complained of shall be entered by the Commission without a formal hearing.
>
> **(b)** Commencing July 30, 2001, the Commission shall conduct rate investigations of all regulated utilities every five years and hold formal hearings as required under subsection (a) of this section.

Additionally, the Commission could recognize that the reasonable rate of return must be part of the contract between the utility and the quality of the services it delivers to its ratepayers.17[1]

17[1] VITELCO cautions that there is no judicial authority to support tying a public utility's rate of return to service and given the compressed schedule there was no opportunity to give both Parties a chance to submit legal briefs on the subject so we do not tie the percentage of allowable return to a percentage of ratepayers who receive adequate services. We are, however, thankful to Mr. Garnett who proposed that VITELCO be financially penalized when it doesn't respond more quickly to repair orders. While the financial penalties imposed are marginal, the ratepayers will be treated with more respect from the telephone company and will be rewarded with small financial premiums (which, however, do not correspond with the costs that businesses suffer when the telephone quits working) when VITELCO underperforms in its responsibility to see that telephone service is quickly restored.

Testimony presented by VITELCO itself at the hearing (through expert witnesses, the current President of the company, and through other documents admitted into the record) established beyond a doubt that Virgin Islands ratepayers have been given unreasonably, insufficient and inadequate services.18[2] To compound this inequity, even these meager and deficient services are unobtainable by many residents. Additional evidence adduced during the hearing through documents presented by both Parties in conjunction with the testimony of witnesses established that VITELCO has not lived up to its obligations under the service quality standards established by the PSC more than 20 years ago. The Hearing Examiner finds, however, that for the first time, current management of VITELCO recognizes its customer service responsibilities and is willing to voluntarily emplace immediate customer service improvement measures which will be outlined in detail in this order. By virtue of the specific authority obtained in 30 VIC 20 highlighted in bold, infra, and through a pretrial agreement with both Parties, the Hearing Examiner announced that the quality of services would be an issue addressed in this hearing. The Hearing Examiner thanks and commends the lawyers for both sides who produced a great deal of information requested by the Hearing Examiner on very short notice. Without the cooperation of these attorneys we could never have been in a position to issue this Order at this time.

18[2] For example, VITELCO's Expert Witness Economist Dr. J. Eisenach testified in his written submission that "the wireline telecommunications infrastructure in the USVI – that is, VITELCO's infrastructure – is far below standard when compared to the mainland United States. I compared service quality metrics in the USVI with service quality metrics in U.S states based on Federal Communications Commission ("FCC") statistics. While neither the FCC's statistics nor VITELCO's perfectly capture all aspects of service quality, the statistics I examined show that the USVI is far behind on overall service quality. Moreover, the availability and usage of advanced services in the USVI, such as broadband Internet access, is also far below par." Dr. Eisenach further testified that the quality of an adequate communications system is a key prerequisite to economic development, a subject more fully explored in the EDC Section of this Opinion.

Were it is within our power to order VITELCO to immediately replace its network and provide current technologically relevant services to Virgin Islanders it would be done, and possibly with the concurrence of both parties. The order would ring hollow, however, because it could not produce the necessary capital to replace the current network and might cause responsible investors to decide that it would be entering a hostile regulatory environment which would prove unproductive to helping the rate payers obtain better services.

There are tangible and temporary measures that can be immediately emplaced that will, at least, improve the customer service relationship between VITELCO and the customers it is ill serving. As we indicated above, we found a sincere and willing President of VITELCO who voluntarily addressed the Hearing Examiner's concerns and, after a long dialog with the Hearing Examiner during the Hearing Examiner's examination of Clarke Garnett, under oath, on the third day of the public hearings, made a presentation that the Hearing Examiner largely adopts in this order.

WHEREFORE, it is ordered that:

(1) Current management will create a new group at VITELCO called the "Proactive Customer Care Team" that will consist of a minimum of four employees focused on Company-initiated contacts with customers through multiple channels: face-to-face interviews with walk-in customers after their experience with VITELCO's business office; random telephone calls to customers to get feedback as to how telephone service is working; telephone calls to a percentage of customers for whom new service was activated to verify that service is working to the customer's satisfaction and to obtain their feedback on how the service activation was handled; telephone calls to a percentage of customers for whom service was repaired to verify that the service was repaired to the customer's satisfaction and to obtain their feedback on how the repair was handled. Based on these customer contacts, the Company will develop an internal process by which internal expectations of customer satisfaction levels will be established and compared with actual results. Information developed by the Proactive Customer Care Team also will be compiled by the Company to help in its ongoing customer care training and in identifying issues most important to customers and those areas that need the most attention.

(2) Beginning January 2009, the Company will make the necessary investments to conduct certified training of its Customer Service Representatives. The focus of this training will be to improve responsiveness to customer issues and provide tools that CSRs can use to address those issues.

(3) The Company will increase the amount of service credits to customers whose telephone is out of service for more than twenty-four (24) hours. Specifically, consistent with the formulae set forth in the 1983 Stipulation in Docket No. 264, VITELCO will agree to pay a service credit for customers who are without telephone service for up to 72 hours that would be calculated by increasing the service credit value in the formula from 1.0 to 1.5; for customers who are without telephone service for more than 72 hours, the Company will agree to pay a service credit that would be calculated by increasing the service credit value in the formula from 1.5 to 2. These enhanced service credits would be available until the Commission completes its review of the current service quality standards, which, as discussed below, is expected to be concluded no later than December 31, 2009.

(4) In order to ensure that VITELCO employees are aware of and understand the importance of the service objectives and surveillance levels to which the Company is currently subject, VITELCO will include this information in future employee outreach efforts. In particular, VITELCO will: (1) provide each employee with a copy of the current Commission-approved service objectives and surveillance levels; (2) post the current Commission-approved service objectives and surveillance levels on the Company's website; and (3) conduct, at least twice annually, meetings **that will involve representatives of the Commission and** each network and customer service group at VITELCO involved in and responsible for the Company meeting the Commission's objectives, at which time those objectives and the Company's performance will be reviewed.

(5) Consistent with the 1983 Stipulation in Docket No. 264, VITELCO will submit monthly service reports to the Commission for all of the current service objectives and surveillance levels, with the exception of Operator Handled Calls (section 9.0) and Dial Service standards (section

10.0), which have been rendered obsolete. Reports for most of these service objectives are currently being provided today, but VITELCO is ordered to submit the additional monthly service reports beginning with January 2009 data, which will be submitted no later than February 28, 2009. **VITELCO is directed to work with the Commission in ensuring the format of these reports complies with the Commission's requirements and reasonably serves its purposes.**

(6) On a semi-annual basis, VITELCO will submit to the Commission a report outlining the process improvements and the network enhancements made by the Company that affect service quality. This report would be filed no later than June 30 and December 31 of each year beginning in 2009. This report also will contain the information necessary for the Commission to verify that the Company has met its other commitments contained herein.

(7) Consistent with the Commission's Technical Consultants' recommendation, VITELCO shall work with the Commission on a collaborative basis to review and update applicable quality of service standards. This process should be completed no later than December 31, 2009.

(8) Once VITELCO has informed a customer that the customer must be at the customer's home at a designated time to meet a service representative, VITELCO is ordered to notify the customer promptly if there is a material change in the scheduled appointment.

VI. OVER OR UNDER EARNING ANALYSIS

Having concluded that the allowable rate of return will be 11.5% does not end the inquiry. We are next required to review some of the key data in the Company's financial records to determine whether they are earning in excess of 11.5% (over earning). If they are over earning funds may be due to the ratepayers. If they are under earning (making a return on investment less than 11.5%) no reduction in rates results from this rate investigation.

Based on the analysis contained in Sections VII to XI in this opinion, the Hearing Examiner concludes that VITELCO is currently earning a 9.28% rate of return on a ratebase of $60, 235,716.00 and thus, is within appropriate limits. If VITELCO was delivering a better product and better services, we would conclude that ratepayers are receiving an adequate benefit for the bargain. Sadly, this is not the case and until VITELCO makes the necessary investments in its own infra-structure, ratepayers pay an average rate but receive below average services.

VII. SPECIAL TAX BENEFIT – THE EDC ISSUE

(i) Discussion

One of the issues in this proceeding, as in prior rate investigations of the Virgin Islands Telephone Company, has been the recognition and accounting of certain tax benefits which VITELCO recognizes the tax benefits it receives from the Virgin Islands Economic Development Commission ("EDC"), and its predecessor, the Industrial Development Commission ("IDC").

All of the participants to this proceeding accept as fact that the Economic Development Commission affords VITELCO tax credits on its gross receipts and property taxes, by means of a contractual agreement between the EDC and VITELCO. VITELCO maintains – and the technical consultants acknowledge – that such benefits are contractually provided in exchange for VITELCO meeting certain obligations set forth in the EDC certificate. VITELCO asserts that the technical consultants' recommendation effectively "flows through the complete benefit of these tax credits by only recognizing the Company's tax expense after the application of the credits." The technical consultants maintain that (1) it is improper to recognize as an expense of the Company taxes that are not and will not be paid; (2) it appears that VITELCO will not meet the current requirements of the EDC certificate, as it would require a tremendous capital investment within a very short period of time; and (3) VITELCO failed to comply with the requirements of the Commission in regard to the temporary pass through of benefits in the previous rate case.

The following is not in dispute:

- VITELCO is currently the recipient of benefits granted by the Economic Development Commission.
- VITELCO was obligated as conditions of the current EDC certificate to: (i) employ more than 350 persons; and (ii) to make capital investments in excess of $75 million while the EDC certificate was in effect. VITELCO had more than the required number of employees at the time the certificate was granted, and has apparently continued to meet that obligation. However, VITELCO has failed to make capital investments even

remotely approaching the required amounts. It is worth noting at this point that at the time the new EDC certificate was approved VITELCO made public commitments to invest at least $100 million in new capital over a five year period; however, nothing remotely like that investment has occurred. In fact depreciation of the existing plant and equipment has significantly eroded the rate base of VITELCO, and continues to cause its diminishing value.

- VITELCO remains eligible to seek renewal of those benefits from the EDC, or other benefits available through other tax abatement or reduction programs. Any determination that VITELCO's EDC benefits merit extension heretofore has been the sole responsibility of the EDC, without any requirement that it address any previously expressed concerns of the Commission.

The treatment of EDC has been the subject of previous actions by this Commission. The issue was addressed in 1992 in Docket 341 in which the Hearing Examiner recommended that amounts VITELCO receives in the form of reduced taxes "be 'flowed through' or reflected in the company's results, with the effect that its rates would be set to conform to the actual taxes to [be] paid, and not the full unabated tax rates." Hearing Examiner's Report, *In the Matter of the Investigation of the Virgin Islands Telephone Corporation for a Rate Decrease,* Docket 341, at 60-61 (Jan. 10, 1992) (excerpts attached as Technical Panel Exhibit TP-4, at 2-6). However, the Commission and VITELCO subsequently entered into a Settlement Agreement dated August 5, 1992 that did not require the flow through of EDC benefits in the Company's rates. Exhibit DEP-9 at 4.

In 2003, in Docket 532, the Commission again addressed the issue of whether VITELCO should be permitted to retain the benefits of its then current Industrial Development Commission ("IDC", now EDC) certificate, without pass through to the ratepayers. Although the Hearing Examiner again concluded that EDC benefits must be factored into the appropriate rates, the Commission overruled the Hearing Examiner and permitted the Company to retain those benefits. That decision was linked to two facts: that the then-current certificate was to expire on September 20, 2003 (within five months) and VITELCO had clearly stated on the record that it did not intend to seek an extension of benefits or a new certificate. The motion made by then-

Commissioner Alric Simmonds to exempt the IDC benefits stated, as did the Amended Order, that if VITELCO later sought an extension or new benefits, VITELCO must advise the Commission, which would then determine whether or not to revisit the issue. VITELCO, as acknowledged, did not advise the Commission of VITELCO's efforts to obtain a new EDC certificate and benefits, although the Commission did eventually become aware of such efforts.[19]

In this proceeding, after reviewing the relevant material, the technical consultants expressed the view that failing to account for the EDC benefits would not accurately depict the telephone company's financial performance and rate of return. In fact, it was the opinion of the technical consultants that the current practice overstates the "net" tax liability paid by VITELCO and, correspondingly, understates the utility's operating income realized. The technical consultants proposed adjusting the Income Statement Income Tax to recognize the EDC benefit when a) calculating Utility Operating Income and b) computing the realized Rate-of-Return in future rate proceedings to determine any over earnings condition.

VITELCO opposed the recommendations made by the technical consultants regarding the EDC benefits, based on essentially three grounds. First, VITELCO argues that forcing the telephone company to pass tax savings through to the ratepayers will frustrate the purposes of the EDC certificate. Second, it argues that the benefits are about to expire. Third, VITELCO suggests that the EDC benefits will provide a mechanism for obtaining much needed capital at effectively no cost to the ratepayers.

The Hearing Examiner must determine how to treat this tax benefit in order to arrive at the rate of return and under earning/ over earning analysis required in rate proceedings.

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19 The Commission's decision in Docket 532 is currently on appeal. *See Flashman v. The Virgin Islands Public Services Comm'n,* Civil No. 501/2003. In connection with that appeal, the Attorney General, in its capacity as counsel for the Commission, filed a memorandum in which it noted the Commission's decision that EDC benefits will "continue to be exempted" from consideration of VITELCO's operating results provided "continuity of rate treatment which provides comfort to investors." Exhibit E-4, at 24.

To the extent that Docket 532 can be construed as permitting VITELCO to charge the ratepayers for tax expenses that it was not in fact incurring, that permission was both limited and conditional – limited to a brief window of time and conditional on no further extension of benefits without notice and opportunity for reconsideration. VITELCO failed to honor either of those terms, and it would now be improper to again follow that limited exemption.

After reviewing the evidence and the record of this matter in Dockets 513 and 532, the Hearing Examiner finds that recognizing the EDC benefit as an offset to tax liabilities before calculating Net Income is reasonable, in the public interest and consistent with the evidence presented in this proceeding

VITELCO is further prevented from realizing the phantom tax because to sustain its position it must first show that it complied with the requirements of the law. It 1] failed to meet its commitment to invest $75 million in its network; 2] failed to notify the PSC that it was seeking a renewal of its benefits; and 3] failed to satisfy its statutory obligation to notify the EDC of a change of ownership (which includes transfers of stock).

This, however, does not end the inquiry. The key question going forward is how to treat potential tax incentives that VITELCO could qualify for in the future. In order to create a platform in which the PSC is an active participant in any future grants by the Virgin Islands to VITELCO, it is necessary to discuss the historical purposes of special taxing provisions granted by Congress to the United States Virgin Islands so that prior to the grant of benefits in the future VITELCO, the EDC (or the Virgin Islands Research and Technology Park, hereafter RT Park), and the PSC all reach an agreement so that there is no dispute in the next rate investigation (as there has been in the last two) as to whether VITELCO can claim the credit and not calculate it as part of the allowable rate of return. The PSC may want to consider reaching a contractual agreement with VITELCO that exchanges the tax benefit for an honest and complete investment in a new network so that Virgin Islanders will finally have the quality of telecommunications service that they deserve and for which they have amply paid for. The Hearing Examiner does not suggest that the PSC must consider granting future tax incentives, only that it is a permissible, available option to use to attract investment capital so that the Virgin Islands telecom services and capabilities will be significantly increased. As the following discussion

suggests, the improvement in Virgin Islands infra-structure leading to quality of life improvements of Virgin Islands residents was one of the key U.S. developmental policy reasons underlying the special taxing measures available in the Virgin Islands. As the following discussion illustrates the tax incentives available to VITELCO through the RT Park are far more significant than the benefits VITELCO received in the 2004-2009 limited extension of the EDC benefits.

Historical Backdrop

The Virgin Islands joined the United States in 1917 but by then US-Caribbean tax policy was already in place. The outcome of the Spanish-American war meant that Puerto Rico and Cuba (and Guam and the Philippines on the other side of the planet) were U.S. Possessions. When the United States began its relationship with the Territories in the Caribbean in 1898, the newly acquired Territories were poor and had been economically oppressed and the U.S. Government sought to help create financial independence. This was not wholly altruistic - if the Territories were not financially independent - they would be financially dependent on the United States.

From the start, merchants in the United States who were required to pay additional duties on goods emanating from Puerto Rico challenged the special revenue laws as unconstitutional in violation of Article 1, Section 8 which required that "all duties, imposts, and excises shall be uniform throughout the United States." The Supreme Court in a line of cases known as the *Insular Cases* used a line of deprecating and racially insensitive reasoning to accord all inhabitants of the Territories less than full constitutional rights. The less than satisfying trade-off in the outflow from the *Insular Cases*, was that the Territories' ability to use special tax laws to develop their economies was not restrained by Article 1, Section 8 of the U.S. Constitution.

The key event in our VI tax history surrounds the Naval Appropriation Act of 1922. When the Navy Governors arrived in the Virgin Islands they found a territory swarming with malaria and filled with poor and neglected inhabitants. The Navy began with the premise that it was to administer a port with military significance and the Navy was challenged by the need for infrastructure investment in the Virgin Islands. So the

Navy went to Congress in 1921 and requested an appropriation to enhance life in the islands. Congress, as it had in 1900, continued its policy of making very little direct investment in the Territories through direct appropriations. Instead they gave the Virgin Islands the right to use the federal income tax (heretofore inapplicable to inhabitants of the Virgin Islands) as a purely local tax to fund necessary investments in infrastructure development. Unwilling to send the U.S. Treasury to the Virgin Islands to collect the tax, Congress told the Navy Governor that it would be the Navy's responsibility to collect it.

From the start the purpose of this 1922 law was "to assist the islands in becoming self-supporting." While economic development of the Virgin Islands was part of stated U.S. policy it did not occur during the period when the U.S. Navy administered the Virgin Islands (1917-1931). Thereafter, the administration of the Territory was transferred to the Interior Department. President Herbert Hoover became the first U.S. President to visit the Virgin Islands and opined during that visit:

> "...[W]e acquired an effective poorhouse, comprising 90 percent of the population. The people cannot be self-supporting either in living or government without discovery of new methods and resources. The purpose of the transfer of administration from the naval to a civil department is to see if we can develop some form of industry or agriculture which will relieve us of the present costs and liabilities in support of the population or the local government from the Federal Treasury or from private charity.... [H]aving assumed the responsibility, we must do our best to assist the inhabitants."

The New York Times, March 27, 1931, p.1. col. 3 and p.23, col

The major U.S. sponsored developmental program developed by Governor Pearson and President Franklin Roosevelt was the establishment of the Virgin Islands Company (VICORP), the only United States sponsored sugar processing company. So strong was the U.S. goal of economic development of the Virgin Islands that at the height of anti-socialism and anti-communism in the United States, the U.S. government formed a socialist collective and sponsored it for 32 years. Congress provided subsidies to operate

VICORP from 1934-1966 when the sugar processing plant was disassembled and moved to Venezuela.

Thereafter, a policy shift from Congressional subsidies to indirect grants in the form of tax incentives was made to help two industrial concerns establish the Harvey Aluminum and Hess Oil refineries. The measures used to create special tax laws to promote industrial development were the predecessor to the EDC program.

The history of the EDC law is complex. The first antecedent to the law appeared in 1957 with Act No. 224 of the Virgin Islands legislature. It was enacted to encourage new business enterprises in the Virgin Islands and provided a tax exemption to those entities.

The preamble to Act #224 stated: "Whereas it is deemed of great benefit to the people of the Virgin Islands, as well as to the economy of the Virgin Islands, to establish as many self- sustaining enterprises in the Virgin Islands as is practical-- to attract additional investment capital-- to promote tourism-- to promote the building of hotels, guest houses, and housing projects-- to the end that the economic life of the Virgin Islands may be as diverse and stable as possible, and the people of the Virgin Islands trained and employed in investments, in finance, in modern techniques of production, mechanical skills, services and trades; and Whereas it is deemed to be in the public interest to extend such inducements and render such aid as will encourage persons, firms and corporations to establish and develop new business enterprises; *to make additional investment capital available* to new and existing business; to promote tourism and the building of hotels, guests houses and housing projects.

The V.I. legislature got a little ahead of Congress in this regard but Congress, agreeing with the objective of the law, ratified it by amending 26 U.S.C. 934 in 1960. "Accepting the 'invitation' extended by Section 934 , the Virgin Islands legislature enacted the Industrial Incentive Program which was substantially the same as Act No. 224, except that it contained the limitations required by Section 934(b) . See 33 V.I.C. 4071(a(2)." *HMW Industries, Inc. v. Wheatley,* 504 F.2d 146, 151-152 (3d Cir. 1974).

The United States Department of Interior continues to recognize that the tax incentives the Virgin Islands is authorized to offer VI businesses is necessary to help offset significant economic hurdles to development. In July, 2005, the Interior Department filed a written statement concerning their own concerns with new tax regulations for the Territories. Their paper noted that "[t]he Secretary of the Interior has stated that her top priority for the Insular Areas is to promote private sector economic development there. Under the Secretary's leadership, the Department of the Interior has been implementing a comprehensive program to advance this priority.... ***Because of the special fiscal and economic challenges faced by the Insular Areas, it has been the policy of successive administrations from both parties to support tax and trade provisions to help the Insular Areas generate sufficient tax revenue and economic activity to meet the most basic needs of their people. Notwithstanding these incentives, each of the Insular Areas continues to experience severe economic and fiscal difficulties. Special tax provisions for the Insular Areas, in particular, manifest an important underlying principle of U.S. territorial policy: The Federal Government does not treat the Insular Areas as sources of revenue. The U.S. has a strong interest in maintaining and enhancing the economic and fiscal well-being of the Insular Areas."*** Statement of the U.S. Department of the Interior, Office of Insular Affairs on Temporary and Proposed Regulations to Implement the American Jobs Creation Act of 2004 (July, 2005). "

VITELCO has exhausted the maximum benefits it could obtain through the EDC program. There is, however, a much more lucrative option for VITELCO going forward in the Research and Technology Park (hereafter RT Park). The University of the Virgin Islands Research & Technology Park (RTPark) is an economic development initiative of the U.S. Virgin Islands leveraging the combined vision of the business community, UVI and the public sector. Chartered through legislation* and affiliated with UVI, RTPark is a world-class, near-shore provider of technology solutions for knowledge-based, information technology and e-commerce companies. Its mission is to attract technology and knowledge-based businesses to the USVI, foster a vibrant and sustainable technology sector, broaden the territory's tax base, stimulate creation of new jobs and career opportunities for residents, and strengthen UVI's academic and financial capabilities.

One of the RT Park's key components is the telecommunication industry in the Virgin Islands. Other players without VITELCO's competitive advantage, have already joined the RT Park in one capacity or another. The RT Park has been waiting to hear from VITELCO but through VITELCO's long history of active neglect, it remains the eight hundred pound gorilla who has shown no interest in entering the room. VITELCO's absence is stunning given the fact that VITELCO's EDC benefits only provided relief from gross receipts and real estate taxes limited to a five year term.[20] In contrast the RT Park could confer, in addition to these tax benefits, a 90% reduction in income taxes for a 15 year term with the possibility of a 15 year extension.[21] But as this community has seen time and again, rather than going through the front door with open communications to all relevant agencies, VITELCO's prior management preferred going through the back door using its own brand of inappropriate influence peddling. Nonetheless, a new opportunity for new management may exist that far surpasses any benefit stream VITELCO enjoyed in the past.

The U.S. Treasury, through IRS Notice 2006-76, announced that it was favorably disposed to assist the Government of the Virgin Islands in its desire to develop a technology sector through favorable tax regulation on income sourcing. The temporary regulations announced in 2006-76 were made permanent when the IRS issued its final sourcing regulations for the Virgin Islands.

So long as all negotiations are coordinated by all essential Virgin Islands Government agencies, the Virgin Islands Government can make an informed decision as to whether it wants

[20] In fact, it would be inappropriate for VITELCO to ask for a renewal of EDC benefits without consultation with the RT Park. EDA and RTPark entered into a Memorandum of Understanding and Agreement dated March 25, 2008, which is downloadable from www.uvirtpark.com. In it, the RTPark is established as "first responder" for "Knowledge-Based Businesses." Telecoms are included in the RT Park's first responder list in Section 1.1.4 of the MOU wherein " businesses whose utilization of communications networks is central to, rather than incidental to, the business" are directed to make application with the RT Park.

[21] See Title 17 Virgin Islands Code, Section 806.

to help finance the cost of a new telecommunications network for Virgin Islanders by establishing a contract with VITELCO[22] in exchange for a state of the art modern communications network with all of the services the other citizens of this country enjoy.

[22] The EDC entered into such a contract in 2004 with VITELCO that, by all accounts, was breached by VITELCO. In the next go around, it is suggested that a mechanism for verification of the investment and the new required performance standards that will follow the change of control hearing, be implemented as part of any new contract between the Government of the Virgin Islands and VITELCO.

VIII. DEPRECIATION SCHEDULE

One of the most contentious issues in this proceeding concerns depreciation. "Depreciation is defined as the loss in service value of a capital asset over time." *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 364 (1986). Depreciation affects the rates that Virgin Islands residents pay for telephone service because, as a regulated utility, VITELCO is "entitled to recover its reasonable expenses and a fair return on its investment through the rates it charges its customers, and because depreciation practices contribute importantly to the calculation of both the carrier's investment and its expenses." *See id.* at 364-365 (citations omitted).

Depreciation rates represent the loss of value in the telephone company's investment in equipment and facilities used to provide telephone service due to causes such as wear and tear, obsolescence, changes in technology, and changes in demand. Depreciation rates are among the expense elements included in a telephone company's revenue requirement, which is the basis for determining the rates that a regulated utility is authorized to charge its customers. *See, e.g., Southern Bell Tel. & Tel. Co. v. FCC*, 781 F.2d 209, 212 (D.C. Cir. 1986); *South Central Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n*, 744 F.2d 1107, 1110 (5th Cir. 1984). As the United States Supreme Court has explained:

> The total amount that a carrier is entitled to charge for services, its 'revenue requirement,' is the sum of its current operating expenses, including taxes and depreciation expenses, and a return on its investment 'rate base.' The original cost of a given item of equipment enters the rate base when that item enters service. As it depreciates over time -- as a function of wear and tear or technological obsolescence -- the rate base is reduced according to a depreciation schedule that is based on an estimate of the item's expected useful life. Each year the amount that is removed from the rate base is included as an operating expense. In the telephone industry, which is extremely capital intensive, depreciation charges constitute a significant portion of the annual revenue requirement recovered in rates ....

Louisiana Pub. Serv. Comm'n v. FCC, 476 U.S. at 365; *see also* Revised Pre-Filed Direct Testimony of Donald E. Parrish, at 3-5.

The Commission has the authority to prescribe the depreciation rates that VITELCO may use for purposes of establishing "local" or intrastate rates. *See Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. at 371-79 (holding that the Federal Communications Commission or "FCC" is prohibited from prescribing depreciation practices and charges for intrastate ratemaking purposes). Based on the evidence in the record, it appears that the Commission last examined VITELCO's depreciation rates in 1992 in Docket No. 341. *See* Pre-Filed Rebuttal Testimony of Donald E. Parrish, at 3-4; Exhibit DEP-8. In connection with Docket No. 341, the Commission and VITELCO entered into a settlement agreement dated August 5, 1992 that authorizes the depreciation schedules utilized by the Company. *See* Pre-Filed Rebuttal Testimony of Donald E. Parrish, at 4; Exhibit DEP-9.

There does not appear to be any serious dispute that VITELCO used the depreciation rates authorized by the Commission in Docket No. 341 in calculating its rate base and operating expenses in this proceeding. Nor does there appear to be any serious dispute that VITELCO used those same depreciation rates in the Commission's previous earnings investigation, Docket No. 532. *See* Pre-Filed Rebuttal Testimony of Donald E. Parrish, at 4-5; Surrebuttal Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 20-21.

However, the Commission's Technical Consultants question the continued reasonableness of the Commission-approved depreciation rates for VITELCO's pole lines and aerial cable, which include a future net salvage factor of 100%. Surrebuttal Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 21. The Commission's Technical Consultants calculate that, because VITELCO "has made minimal retirements" in its pole lines and aerial cable accounts, VITELCO's depreciation reserve for aerial cable is 137%, while its depreciation reserve for pole lines is 102%. *Id.* at 21-22. According to the Commission's Technical Consultants, at VITELCO's rate of retirements in 2008, "it would take 36 years for the rate of retirements to equal the excess of depreciation reserve over original cost for the aerial cable account." *Id.* at 22-23. Therefore, the Commission's Technical Consultants

recommend that the Commission adopt the mid-point of depreciation life and salvage ranges adopted by the FCC, the effect of which would be to lower VITELCO's depreciation rates in the aerial cable and pole line accounts. *See* Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 46.

VITELCO counters that a future net salvage value is a proper component in depreciation rates and contends that the fact that the accumulated depreciation reserve may exceed the gross value of investment in the aerial cable and pole line accounts is not surprising given the future net salvage factor authorized by the Commission in Docket No. 341. *See* Pre-Filed Rebuttal Testimony of Donald E. Parrish, at 7. According to VITELCO witness Parrish, significant portions of VITELCO's pole lines and aerial cable plant have remained in service over a period in which the full cost of removal has been accrued through depreciation rates, but the mere fact that those costs have yet to be incurred is not an indication that the accruals are inappropriate. *Id.* Furthermore, VITELCO argues that the full cost of removal will be incurred by the Company when it actually removes fully depreciated pole lines and aerial cable and predicts that the pace of removal is likely to increase once the new owner begins to make expected network investments. VITELCO also questions the validity of using FCC-prescribed depreciation lives, which, according to VITELCO, (i) have no bearing on the establishment of local rates, (ii) were not developed taking into account the unique circumstances facing VITELCO's network in the Virgin Islands, and (iii) do not apply by design to rate-of-return carriers like VITELCO. *Id.* at 8; *Simplification of the Depreciation Prescription Process*, CC Docket 92-296, FCC 93-452, ¶¶ 1 & 7 (1993) (Exhibit TP-5).

The Hearing Officer agrees that VITELCO should not be entitled in the future to depreciate its telephone poles at 200% of its costs. This is patently unreasonable and does not comport with persuasive authority from other rate cases within the geographical bounds of the Third Circuit states and territories. See *Pennsylvania Power & Light Co., v. Pennylvania PUC* 311 A2d 151 (Pa 1973)(a public utility will not be permitted to recover, by annual allowance for depreciation, a total amount in excess of original cost investment).

However, it is unnecessary to resolve the disagreement between the parties concerning whether FCC-prescribed depreciation charges should be used for purposes of this proceeding.

The depreciation rates that were used to set VITELCO's current rates that are at issue in this proceeding were authorized pursuant to a settlement agreement between VITELCO and the Commission. VITELCO is contractually entitled to rely upon its contract with the Commission and to have the justness and reasonableness of its current rates evaluated based upon the depreciation rates in that contract.

The Hearing Officer is persuaded by the reasoning of *Centex Corp. v. U.S.*, 395 F.3d 1283 (Fed. Cir. 2005), in which the U.S. Court of Appeals for the Federal Circuit upheld a lower court ruling that Congress cannot revoke tax benefits promised as part of an agreement to acquire troubled savings and loan associations. The benefits in question arose when Centex Corp. contracted with the Federal Savings and Loan Insurance Corporation ("FSLIC") to acquire a number of troubled thrifts. The contract provided that the government would make "assistance payments," which represented the difference between the book basis of certain assets and the value of those assets when they were sold or written down. In addition, Centex was permitted to deduct the losses that were the basis for the assistance payments. Believing the benefits of this deal were excessive, Congress passed the Guarini amendment that "purported to 'clarify' the tax treatment of FSLIC assistance payments to institutions that were acquiring failed thrifts, but it had the effect of disallowing such institutions from claiming deductions for the built-in losses on assets covered by the FSLIC assistance agreements." *Id.* at 1289-90.

The trial court and the Federal Circuit both held that the government breached its implied covenant of good faith and fair dealing with Centex when it retroactively disallowed the benefits to which Centex was entitled under the contract with the FSLIC. The trial court found, and the Federal Circuit agreed, that Centex "reasonably regarded the availability of tax deductions for the built-in loses as an important part of the contract consideration and [] reasonably expected the government not to withhold that consideration by legislation specifically targeted at that contract." *Id.* at 1304-05. The Federal Circuit agreed with Centex that "the government should be prohibited from interfering with [its] enjoyment of the benefits contemplated by the contract, which is among the core functions served by the implied covenant of good faith and fair dealing." *Id.* at 1306.

In this case, as in *Centex*, VITELCO executed a contract with the Commission by which it was promised, among other things, the right to use certain depreciation rates for rate-setting purposes. VITELCO relied upon that promise when it used those depreciation rates to establish the rates it currently charges its customers, and it should be able to continue to rely upon that promise in having the Commission assess in this proceeding whether current rates are just and reasonable. Of particular significance is the fact that the Commission was not required to consent to the use of particular depreciation rates as part of a settlement agreement. The Commission did so, however, "in order to avoid further litigation," Exhibit DEP-9, at 1, and the policies supporting contractual enforcement of that agreement apply. Similarly, as in *Centex*, the implied covenant of good faith and fair dealing requires that the Commission honor its contractual commitments.

The *Centex* court relied heavily on the Supreme Court's opinion in *United States v. Winstar*, 518 U.S. 839 (1996). In that case, the FSLIC lacked the funds to liquidate all of the savings and loan associations (thrifts) that were failing during the early 1980s. *Id.* at 845. As a result, the Federal Home Loan Bank Board ("FHLBB") entered into contracts with some financially healthy thrifts under which, in return for the healthy thrifts' takeovers of financially ailing thrifts, the acquiring thrifts were permitted to designate the excess of the purchase price over the fair value of identifiable assets as supervisory goodwill and to count such goodwill and certain capital credits toward the capital reserve requirements imposed on thrifts by federal regulations. *Id.* at 847-48. Subsequently, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which contained a provision forbidding thrifts from counting the goodwill and capital credits in computing required capital reserves. *Id.* at 856. Of the three thrifts that had been created by supervisory mergers, two were seized and liquidated by federal regulators for failure to meet applicable capital requirements, and the third, which also had fallen out of capital compliance, avoided seizure through a private recapitalization. *Id.* at 858. Believing that the FHLBB had promised that the supervisory goodwill could be counted toward the capital reserve requirements, each of the three acquiring thrifts filed suit against the United States and sought monetary damages on the basis of theories that included breach of contract. *Id.*

The Federal Circuit held that, when the law as to capital requirements changed and the government was unable to perform its promise, the United States became liable for breach of contract. *Id.* at 859. The Supreme Court affirmed, finding that the government was contractually obligated to use supervisory goodwill and capital credits in calculating the thrifts' net worth – an obligation the government was bound to honor, notwithstanding the new regulatory capital requirements imposed by FIRREA. *Id.* at 870. The Court reasoned that the government may wish to further its regulatory goals through contracts and such contracts should be enforced, except in the event sovereign authority is effectively limited. *Id.* at 880. The *Winstar* Court was persuaded that no sovereign power was limited by the government's promise to use supervisory goodwill and capital credits in calculating the thrifts' net worth, and the plaintiffs sought nothing more than the benefit of promises by the government to insure them against any losses arising from future regulatory change. *Id.* at 890.

The facts in *Winstar* and in this case are similar. In *Winstar* the plaintiff thrifts negotiated contracts with bank regulators that addressed the accounting treatment to be accorded supervisory goodwill and capital credits. Likewise, in this case the Commission and VITELCO negotiated a contractual settlement agreement that, among other things, authorized the depreciation rates used to establish the rates at issue in this proceeding. For the same reasons that the Government was bound to honor its contract with the plaintiff thrifts in *Winstar*, the Commission is bound to honor its settlement agreement with VITELCO by determining whether VITELCO's current rates are just and reasonable based on the depreciation rates in that agreement. *See also Tamerlane, Ltd. v. U.S.*, 81 Fed.Cl. 752, 763 (2008) ("When the government as contracting party makes a promise in exchange for a benefit, it is bound by mutual obligations, as any party to a contract is bound") (citing *First Nationwide Bank v. U.S.*, 431 F.3d 1342, 1350-51 (Fed. Cir. 2005)).

Although the Hearing Officer is persuaded that the depreciation rates authorized by the Commission's settlement agreement with VITELCO should be used in this proceeding to assess whether VITELCO's current rates are just and reasonable, this does not mean that those depreciation rates must remain in place in perpetuity. The Commission and VITELCO always

have the ability to agree to new depreciation rates for rate-setting purposes. In addition, the Commission has the discretion to initiate a proceeding to reexamine VITELCO's depreciation rates, but it must first provide reasonable notice of its intent to do so. No such notice was provided here.

In light of the questions raised by the Commission's Technical Consultants about VITELCO's current depreciation rates, the Hearing Officer believes that those rates should be reexamined after new ownership of VITELCO has had sufficient time to develop its infrastructure deployment plans and decide what technologies and facilities it intends to deploy in its network. Consequently, the Hearing Officer:

(1) formally places VITELCO on notice that it will not be permitted to rely upon current depreciation rates in the Commission's next rate investigation;

(2) directs that no later than December 31, 2009, VITELCO shall complete and submit to the Commission a new depreciation study that will address both investments in existing plant facilities and new investments on a prospective basis;

(3) recommends that, within 120 days after VITELCO's submission of the new depreciation study or by April 30, 2010 in the event that VITELCO fails to submit such a study, the Commission will decide whether: (a) to accept or reject that study; or (b) enter into an agreement with VITELCO on new depreciation rates that take into account the unique circumstances faced by a telephone company operating in the Virgin Islands;

(4) in the event that the Commission neither accepts nor rejects VITELCO's new depreciation study and does not enter into an agreement with VITELCO on new depreciation rates within the timeframes referenced above, authorizes VITELCO to use the depreciation rates in its new depreciation study for the calendar year 2010 and thereafter until such time as a new depreciation agreement is in place between VITELCO and the Commission; and

(5) in the event that VITELCO does not submit a new depreciation study by December 31, 2009, or in the event that the Commission rejects VITELCO's new depreciation study and does not enter into an agreement with VITELCO on new depreciation rates within the timeframes referenced above, directs VITELCO to use the highest depreciation rates yielded by the

depreciation ranges adopted by the Federal Communications Commission in *1998 Biennial Regulatory Review - Review of Depreciation Requirements for Incumbent Local Exchange Carriers,* Report and Order, 15 FCC Rcd 242, CC Docket 98-137 (Dec. 30, 1999), for the calendar year 2010 and thereafter until such time as a new depreciation agreement is in place between VITELCO and the Commission.

IX. ADVISORY FEES and AFFILIATE TRANSACTIONS

At the moment, VITELCO is a wholly-owned subsidiary of Innovative Communications Corporation. Historically, VITELCO had maintained a number of business relationships with other subsidiary business units of Innovative Communications Corporation that are governed by long-term service agreements or contracts. In general, these business relationships represent an exchange of goods/services between the business units that are needed and/or necessary for the recipient to fulfill their corporate obligations. Services generally covered by such affiliate agreements include tax and accounting services, office space, computer service, strategic planning and procurement.

It is apparent that exchanging services between affiliate – and the use of affiliate agreements to govern the terms and conditions of those exchanges -- is a common practice in the telecommunications industry. Yet such transactions provide an opportunity for great mischief and abuse that can negatively impact ratepayers. The principal criticism levied against affiliate transactions is that they present the means for parent corporations to burden the regulated company with the responsibility of providing services to competitive subsidiaries at prices that are below their own cost or the cost that the market would command to perform the same task – effectively providing the competitive entity an unwarranted subsidy. Other critics of affiliate relationships fear unregulated affiliates will be accorded "sweetheart" contracts that provide them a sustainable competitive advantage against prospective competitors – or better yet preclude others from entering the market by granting them exclusive rights.

To allow VITELCO to use its own numbers and accounting methodologies to institute inter-company advisory fees requires a certain amount of trust in VITELCO. VITELCO interim President Clarke Garnett established that VITELCO's past management could not be trusted and the PSC cannot be required to accept VITELCO's numbers on inter-company advisory fees. On the issue of what kind of money has been taken from VITELCO by former management the following exchange occurred at the November 7, 2008 St. Thomas Public Hearing:

> Question (by Attorney Sprehn): "Your counsel and other people speaking here have previously used the term "looted" to describe what happened to VITELCO.... Can you give us a ballpark number as to how much cash, whether it is characterized as dividends,

fees, loans, or in whatever form, were transferred from VITELCO to the parent entities over the last five years of the prior management?" Answer (by Mr. Clarke Garnett): "Tens of millions. Beyond that, I really couldn't tell you. But as we talked about the way the accounting system worked, money came in, and it all was swept up to ICC."

Judge Watts discussed the advisory fee issue in Docket #532 and indicated that appropriate subjects of an evaluation of affiliate transactions could include answering the following questions:

- is the service provided by the affiliate needed and necessary by the contracting party?
- is the affiliate providing the service sufficiently competent and capable of providing the service to the contracting party
- is the service provided by the affiliate a duplication of effort to that performed by the contracting party for the same service?
- is the price charged for the service competitive to the price charged for similar service in the marketplace?
- is the contracting party able to exercise sufficient control over the performance of the affiliate so as to ensure completion of the assigned task?

See Opinion of Hearing Examiner, Docket #532, p. 38.[23]

Since VITELCO, after the Bankruptcy Auction, will either be independent or will have a new corporate parent, it is unnecessary to undergo an exhaustive analysis of past history on this point. However, the PSC Consultants propose a very reasonable system of allowing and limiting necessary cost adjustments with respect to inter-corporate advisory fees.

[23] Judge Watts also opined that " [t]he scope and structure of this rate proceeding does not provide the necessary framework or evaluation standards needed to perform such a review." Id. at 38. Thus, we are unaware of whether such an evaluation has been conducted. Moreover, VITELCO and its bankrupt parent will soon be bidding each other farewell so it is not necessary in Docket #578 to undergo a comprehensive examination.

X. MARKETING EXPENSE

The parties appear to agree that marketing is an operating expense that typically should be included in calculating a regulated utility's revenue requirement. However, in this case VITELCO did not incur marketing expense in 2007 or the first seven months of 2008. Under these circumstances, the Commission's Technical Consultants recommend that no expenses associated with marketing be included in VITELCO's revenue requirement calculation. Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 53-54. The Commission's Technical Consultants also question the need for "an immediate large scale marketing campaign" given the limited competition that VITELCO currently faces. Surrebuttal Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 29.

The Hearing Examiner is not convinced that the fact that VITELCO has refrained from marketing in the recent past is necessarily reflective of the marketing that VITELCO will undertake on a going-forward basis. As Mr. Parrish testified, VITELCO curtailed its recent marketing efforts, which previously were handled at the parent company level, due to financial considerations and previous mismanagement. *See* Pre-Filed Rebuttal Testimony of Donald E. Parrish, at 17.

VITELCO has created structural problems for itself by ignoring its network which has essentially stopped the production of new and improved products and services to Virgin Islanders. This has hurt residents and business owners. This has hurt the development of the economy of the Virgin Islands and this has hurt VITELCO because the telephone company is losing customers and actual and potential revenue streams.[24]

It is no wonder that VITELCO has curtailed marketing expenses. What could they possibly say to Virgin Islanders to encourage the sale of new products and services. There are

[24] According to the rebuttal testimony of expert witness David Blessing, "VITELCO's revenues have fallen approximately 3% over the period 2004 to 2007. During this same period of time, VITELCO's minutes of use and number of access lines declined by 12.1% and 9%, respectively.

none. However, the PSC wants the new owner to make a significant investment in network architecture to improve products and services to Virgin Islanders and the PSC is well within their mandate to encourage a new owner to make the necessary investment to replace a network that largely does not work and can't be improved through the application of more scotch tape and bailing wire. If VITELCO makes such an investment and brings those products and services to our shores, then VITELCO should be encouraged to communicate those changes to the community. Indeed, VITELCO has a constitutional right to recover legitimate marketing costs. See *Central Hudson Gas & Elec. Corp. v. Public. Serv. Comm'n*, 447 U.S. 557 (1980) and the discussion below.

The Hearing Examiner believes that VITELCO will need to engage in marketing and will thus incur marketing expenses during the period when the rates under examination are in effect. *Id.* at 17-18. This is particularly true once VITELCO is under new ownership. The Hearing Examiner is persuaded that the new owner will need to communicate with and educate customers about the changes being made and that these efforts will only intensify as the new owner makes available new products and services. 11/05/2008 Transcript at 128-131; 11/6/2008 Transcript at 111-112.

The Hearing Examiner also is concerned that the failure to include reasonable marketing expenses in the calculation of VITELCO's revenue requirement could have the practical effect of denying VITELCO the ability to engage in marketing, which has First Amendment implications. For example, in *Central Hudson Gas & Elec. Corp. v. Public. Serv. Comm'n*, 447 U.S. 557 (1980), the United States Supreme Court held that an electric utility had a First Amendment right to engage in promotional advertising and struck down a state commission order banning such commercial speech. The Court held that even a public utility that faces little or no competition "legitimately may wish to inform the public that it has developed new services or terms of doing business" and that such information aids a consumer's "decision whether or not to use the ... service at all, or how much of the service he should purchase." *Id.* at 567; *see also Virginia State Bd. of Pharmacy v. Virginia Citizens Consumer Counsel*, 425 U.S. 748 (1976) (holding that truthful, nonmisleading advertising was entitled to First Amendment protection); *Bates v. State*

Bar of Ariz., 433 U.S. 350, 384 (1977) (invalidating on First Amendment grounds a ban on truthful advertising relating to legal services).

As the Court made clear in *Central Hudson*, the First Amendment protects not only the interests of the entity engaged in commercial speech but also the interests of consumers who benefit from the dissemination of truthful information about available products and services. *Central Hudson*, 447 U.S. at 563 ("The First Amendment's concern for commercial speech is based on the informational function of advertising"); *see also 44 Liquormart/Peoples Super Liquor Stores v. Rhode Island*, 517 U.S. 484, 495 (1996) ("[T]he law has developed to ensure that advertising provides consumers with accurate information about the availability of goods and services"); *Edenfield v. Fane*, 507 U.S. 761, 766 (1993) ("First Amendment coverage of commercial speech is designed to safeguard" society's "interes[t] in broad access to complete and accurate commercial information").

Here, it is extremely important that the residents of the Virgin Islands receive timely information about VITELCO as a result of the change in ownership. Because of the service problems that have plagued the Company under prior management, the new owner of VITELCO will have little choice but to proactively communicate with customers by marketing itself and its services. The First Amendment protects VITELCO's interest in engaging in such marketing efforts and customers' interest in obtaining information from such marketing. A decision that effectively precludes VITELCO from engaging in marketing by denying the Company the ability to recover through rates the reasonable expenses associated with its marketing efforts would be contrary to the First Amendment.

However, the Hearing Examiner agrees with the Commission's Technical Consultants that VITELCO's proposed marketing expense of $923,813 is troublesome. Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 54. VITELCO calculated its proposed marketing expense based on the same benchmarking study that it used to estimate the advisory fees the Company will pay on a going-forward basis for corporate operations expenses. *Id.*; Pre-Filed Rebuttal Testimony of Donald E. Parrish, at 26-27. The Hearing Examiner does not accept VITELCO's proposed marketing expense for the same reasons that the Hearing Examiner did not accept VITELCO's proposed expenses for corporate operations.

Nevertheless, the Hearing Examiner believes that there is evidence in the record that would support an estimate of marketing expense that is more reflective of the marketing expenses the new owner will incur going forward. Specifically, the Hearing Examiner believes that the level of marketing expense originally proposed by VITELCO should be reduced by the same ratio reflective of the reduction in the corporate operations expenses from what VITELCO proposed relative to the Commission's Technical Consultants' proposed corporate operations expenses, since both categories of expenses as proposed by VITELCO were based on the same benchmarking study. This approach results in a marketing expense of $825,888, which the Hearing Officer finds is reasonable and which should be included the calculation of VITELCO's revenue requirement.[25]

[25] The Commission's Technical Consultants proposed a cost for corporate operations expense of $158.06 per line as compared to VITELCO's proposed $176.72 cost per line. Exhibit DEP-10. This is a difference of 10.6%, which, when applied to VITELCO's original proposed marketing expense of $923,813, results in a reduced marketing expense of $825,888.

XI. MINOR ISSUES

There are two additional issues upon which the parties disagree in assessing whether VITELCO's current rates are just and reasonable. First, the Commission's Technical Consultants propose that VITELCO's rate base be reduced by $473,000 to reflect a balance in accounts payable related to materials and supplies that, according to the Commission's Technical Consultants, "have not been paid for and therefore do not represent an investment made by investors." Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 41. VITELCO counters that such an adjustment would amount to "double jeopardy" by factoring accounts payable twice in the calculation of VITELCO's revenue requirement, once as a reduction in the allowance for working capital and again as a direct offset to rate base. Rebuttal Testimony of William J. Warriner, at 13-14.

Second, the Commission's Technical Consultants recommend an "interest synchronization adjustment" that would reduce VITELCO's deductible interest expense by approximately $101,000 and thereby reduce the Company's cash working capital requirements in calculating VITELCO's rate base. Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 64-65. This proposed adjustment was calculated based upon the weight and cost of debt, which the Commission's Technical Consultants assumed was 3.37%. *Id.* at 64; Schedule 12.

The accounts payable and interest synchronization adjustments were the subject of relatively little testimony at the hearing, and neither issue was addressed fully by the parties. The lack of attention to these issues may be due to the fact that, even if accepted by the Hearing Examiner, neither adjustment would have any material impact on VITELCO's rate base, revenue requirement, or rate of return. Technical Panel Exhibit 8. Under the circumstances, the Hearing Examiner finds it to be unnecessary to address the merits of either proposed adjustment in this proceeding.

XII. CHANGE IN CONTROL – NETWORK INVESTMENT

As we indicated earlier in this Opinion, Counsel for VITELCO and the PSC agreed in the original proposed scheduling order to include change of control issues in this rate investigation. During the course of the public hearing, the Hearing Examiner determined that it would be difficult to reach conclusions and to make effective Orders given the fact that no one knows who the new owner will be and whether the Creditors and the Bankruptcy Court will approve the sale of the Company. See written testimony of Adam Dunayer who opined that it was unlikely that the Bankruptcy Court would approve a sale of the Group 1 assets if the bid is less than $185 million. We thus concluded that we would use this hearing to create a structure for the upcoming change of control hearing and to make recommendations to the Commission for discussion during the change of control hearings that will follow a successful Bankruptcy sale.

We will analyze all of the issues and positions taken by the various experts on this issue but before going through the analysis it is important to discuss several underlying principles the Hearing Examiner used in reaching these recommendations. First of all, ownership of a public utility implicates materially different duties than ownership of other companies. Companies are valued by what they own and what they produce and what they deliver less the costs of production and delivery of services. Utilities like VITELCO have different assets. In our case the most valuable asset VITELCO has is its subscriber base. The Hearing Examiner believes that one of the methods by which bidders will analyze the value of the company is through the number of subscribers that come with the company. That means that the ratepayers are the key asset. The ratepayers have already paid for a network that VITELCO promised but failed to deliver. There was quite a bit of testimony during the hearings wherein even VITELCO witnesses opined that Virgin Islands ratepayers should not have to pay a second time for a network that they have already paid for. The Hearing Examiner concludes that while these sentiments are noble, it is inconceivable that ratepayers won't end up paying a second time for the new network that was promised to them over and over during the years the previous management group ran VITELCO's network into the ground. So let us all recognize that the ratepayers will be paying a second time for this network. The real question is how can we

guarantee that when the ratepayers give VITELCO money for this network that VITELCO will deliver?

This is more than an academic question because Interim VITELCO President Clarke Garnett testified that there is at least $18 million dollars a year that VITELCO generates that could be invested in infra-structure. Unfortunately, it is the Hearing Examiner's belief that the bidders are looking at that cash flow as a means of structuring the financing of the purchase of the company. Where then does that leave the ratepayers?

By virtue of this Opinion a road map has been established that might provide significant tax subsidies to help the new owner make the necessary investment in a new telecommunications network. [26] And further in this section is another guidepost that illuminates another potential revenue stream through registration of a coordinated restitution claim in the potential criminal cases that will, in all likelihood, follow.

The PSC and the new owners must respect the fact that the revenue stream generated here comes from ratepayers whose contractual right to receive good telephone services has been breached and will continue to be breached until a new network is in place.

In addition, it is painfully obvious that if VITELCO does not make the necessary investment in its network it will continue to lose subscribers and its ratebase will continue to decline. With no investment in the network, alternative technologies will ultimately replace a good part of VITELCO's business. Ergo, it is in the new owner's interest to make the investment.

If a new owner comes to the PSC with anything less than a commitment to emplace a new network, the Commission should begin to wonder whether the new owner is simply looking for a way to strip out the income from a cash cow and flip the telephone company in a

[26] It is possible that some of the existing network may be salvaged. According to Keith Milner there are some parts that can be saved and reused. By stating that the network needs to be replaced, the Hearing Examiner is not suggesting to VITELCO how this is to be achieved and is not telling VITELCO not to use those elements of its network that may have value. No longer will VITELCO be allowed to take the position that telephone line noise must be tolerated by ratepayers because to eliminate line noise a new network must be installed.

subsequent sale. Were that to happen, it would be our recommendation not to offer VITELCO any competitive protection in the future. Simply put, it is the ratepayer's money that creates value in VITELCO and the ratepayers deserve more than they are currently receiving from this telephone company.

The following observations and recommendations are set forth for the purpose of alerting the Commission, the Bankruptcy Trustee, and the bidders to the issues open for discussion at the change of control proceedings.

First of all, all parties agree with the Commission's position paper adopted on May 9, 2008 in the Commission's Docket 558 proceedings relating to VITELCO's continuing financial viability and the monitoring of the Chapter 11 proceedings of VITELCO's parent entities. That position statement contained many of the same requirements (Appendix B, Technical Consultants Surrebuttal), albeit in less detail:

1. that the Buyer has the financial resources to complete the sale;
2. that the Buyer will install a competent and proven management team that possesses a full understanding of the regulations governing utility companies in the Virgin Islands;
3. that the purchased utility will have a capital structure similar to other utilities of comparable size, and can provide evidence of adequate future capitalization; and
4. that the Buyer and purchased utility have a reasonable capital expenditure program that addresses both immediate service needs as well as service expansion and technology improvements, where warranted, subject to approval by the VIPSC.

The Commission's Technical Consultants have proposed a series of transfer of control guidelines that they recommend be adopted in this proceeding. Testimony of Frank Burdetti, at 6-7, Appendix B; Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 27-29. These guidelines include a recommendation that the new owner of VITELCO "commit to a capital expenditure program of an average of $20 million per year for the next five years" and that this program "be based on the priorities" set forth by Commission Technical Consultant Glenn Deuchler. Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 28-29; Testimony of Glenn Deuchler, at 14-17. The issue of network investment is critical to the future of VITELCO and its customers.

The parties agree that VITELCO's network is currently in poor condition. Based on a physical inspection of VITELCO's plant on all three islands, Commission Technical Consultant Deuchler testified that VITELCO's buildings and outside plant generally are "in very poor condition" and that its "outside plant has been seriously neglected." Testimony of Glenn Deuchler, at 5-6; Exhibit GHD-2. VITELCO consultant Keith Milner conducted a similar inspection of the network and reached similar conclusions, noting that the vast majority of the network facility sites he inspected were in "poor" condition and that the level of disrepair he observed was "pervasive." Direct Testimony of W. Keith Milner, at 21; Exhibit WKM-2; 11/6/2008 Transcript at 116-117.

In addition, according to Mr. Milner, "VITELCO's network is seriously outdated," as newer technology – such as soft switches and Internet Protocol (IP) transport capabilities – "that is common in almost every telecommunications network on the mainland is virtually absent from VITELCO's network." Direct Testimony of W. Keith Milner, at 4-5. The poor condition of VITELCO's network and the Company's failure to incorporate newer technologies has adversely affected customers, both in terms of the lower quality of service they receive and their inability to take advantage of new and innovative services. Direct Testimony of W. Keith Milner, at 4-5 & 10-11; Direct Testimony of Dr. Jeffrey A. Eisenach at 7-12.

The parties also agree that significant network investment will be required in order to improve and modernize VITELCO's network, although they disagree about the amount of such investment and whether a specific investment commitment should be required in this (as opposed to the change in control) proceeding. The recommendation by the Commission's Technical Consultants that the new owner of VITELCO be required to commit to a $100 million capital expenditure program over a five-year period is based on Mr. Deuchler's analysis of the capital spending of AT&T, Verizon and Qwest. Based on data from these three companies, Mr. Deuchler derived an average amount of capital spending per wireline access line figure that he applied to the number of access line served by VITELCO. Taking into consideration inflation and the cost of living as well, Mr. Deuchler opined that VITELCO should establish a capital budget in the range of $17 million to $20 million annually for the period 2009 through 2013. Exhibit GHD-2, at 14-15.

Mr. Milner disagreed with Mr. Deuchler's approach and criticized the attempt to extrapolate investment requirements for VITELCO based on the experiences of the three largest carriers in the United States. According to Mr. Milner, AT&T, Verizon, AT&T and Qwest have little in common with VITELCO: they enjoy vastly different economies of scope and scale; they do not face the widespread network problems of the type and severity that VITELCO faces; they have over time continued to deploy state-of-the-art technology, while VITELCO's technology is for the most part stuck in the 1980s; and they have made very different network architecture choices that make it impossible to draw conclusions about an average level of network investment that should be required of VITELCO. Rebuttal Testimony of W. Keith Milner, at 11-12; 11/6/2008 Tr. at 107-109.

VITELCO did not develop an estimate of the amount of network investment that will be required going forward. In Mr. Milner's opinion, the timing of this proceeding did not permit the preparation of an accurate capital budget, which, according to Mr. Milner, requires "methodically figur[ing] out what you've got, what you need, and what it's going to cost to replace the parts that need replacing." 11/06/08 Transcript at 130-31. However, there is the evidence in the record which suggests that a capital budget of $20 million annually would not be unreasonable. For example, VITELCO's level of current depreciation is approximately $20 million annually, and VITELCO witness William Warriner, when he was a consultant to the Commission in 2004, opined at the time that it was reasonable for VITELCO to make network investments in an amount "equal to its annual provision for depreciation expense." Surrebuttal Testimony of Glenn Deuchler, at 4; Surrebuttal Testimony of Jamshed K. Madan, Walter Schweikert, and Michael D. Dirmeier, at 9, n.2.

Nevertheless, the Hearing Examiner declines to mandate in this proceeding a specific network investment commitment that the new owner must satisfy. The Hearing Examiner is persuaded that mandating such a commitment in this proceeding would be counterproductive to the sale process. Rebuttal Testimony of Adam Dunayer, at 10-12. As Adam Dunayer, who is directly involved in efforts to sell VITELCO, testified: "It's clear that money needs to be spent, and a lot of money needs to be spent, but boxing a buyer into a specific number is probably not

only a mistake, but a limitation or a red flag to a buyer that will reduce what they're willing to pay, or potentially their interest in being the buyer." 11/06/2008 Transcript at 16-17.

This is not to diminish the importance of network investment or the need to have the new owner commit to a certain level of network investment necessary to improve service quality and to make available new services to the residents of the Virgin Islands. Once a qualified buyer has been identified and seeks Commission authorization for the transfer of control of VITELCO, however, the Commission and the buyer will have the opportunity to reach agreement on this issue. The Hearing Examiner believes that the buyer should have input into the specific investment commitments that should be required, taking into account the technology the buyer intends to utilize and the services it plans to offer.

All potential bidders would be wise to recognize that the network must be updated and probably replaced. The Hearing Officer understands that the new owner will need six to nine months to complete an engineering report and reach conclusions as to the best type of technology to run the new network.

The Hearing Officer recommends that the PSC set as conditions for a change in ownership the following:

1. The Buyer must demonstrate that it has the financial resources to complete the sale and to provide the necessary services; the new owner should be financially viable. It should have the ability to provide both long term capital and working capital. The new owner should provide an opening balance sheet for all three Group 1 assets to allow reconciliation of the total buyer purchase price to each of the individual companies' assets. Although the VITELCO is the only one of the three regulated as to local revenues, both of the cable companies are subject to review and approval of the transfer of the franchises. A reasonable allocation of the purchase price to each entity is critical in determining future revenue requirements and maintaining access to capital. VITELCO's balance sheet should be free and clear of liens, claims and encumbrances.[27] The capital structure should be a reasonable approximation of rate base.

[27] Both parties agree that VITELCO's current capital structure is inappropriate going forward, in that there effectively is no equity and that the Company has very limited, if any, access to capital

2. The Buyer will install a competent and proven management team that possesses a full understanding of the regulations governing utility companies in the Virgin Islands;
3. The purchased utility should have a capital structure similar to other utilities of comparable size, and can provide evidence of adequate future capitalization. Note that the PSC's Technical Consultants suggest a balanced capital structure of approximately 50% debt and 50% equity as a target. We will not mandate what the capital structure look like so long as there is a reasonable business plan that shows the Commission where the money is coming from to build a new network.
4. The Buyer and purchased utility have a reasonable capital expenditure program that addresses both immediate service needs as well as service expansion and technology

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markets necessary for operations and reinvestment. The Technical Consultants propose that the new company have a capital structure similar to that of other telephone companies in the United States. Their testimony indicates that approximately 50% debt and approximately 50% equity would be appropriate. They indicate that this capital structure may not be possible at the time of the transfer of control but should be the target range to be achieved in a reasonable period of time and that such a structure would assist in preventing the types of abuse that were apparently undertaken by the previous owner of VITELCO. The Technical Consultants also recommend that VITELCO's balance sheet should be free and clear of liens, claims and encumbrances and that the capital structure should be a reasonable approximation of rate base. VITELCO's witnesses left open the disposition of the preferred stock and all current indebtedness. As the Commission's position paper makes clear, ratepayers must not be burdened with obligations to repay funds that were not used in the provision of telephone services.

> "To the extent that the amounts paid by the new owner of VITELCO to settle the Preferred Shareholder claims and the PBGC's pension liens are sought for inclusion in VITELCO's rate base, and ultimately be borne by the ratepayers, such amounts may not be recovered from the ratepayers unless and until the matter is fully and fairly determined to be appropriate by the VIPSC through the regulatory process as mandated by statute." (Position Paper page 10.)

Testimony by the Technical Consultants showed, and the Company agreed, that very little, if any, of the proceeds of the preferred stock issuance was for the benefit of the ratepayer. Further, the amounts due to the pension funds had been included in the rates already established and collected, and ongoing. Consequently, the Hearing Examiner cautions that if the transfer of assets is not free and clear of claims of the preferred shareholders and the amounts owed to the debt holders including the PBGC, ratepayers should not be required to repay these amounts through future rates.

improvements, where warranted, subject to approval by the VIPSC. The evidence developed in this case suggests that this investment could be as much as $100 million dollars but we will not mandate that the new owner spend a certain amount of money. Rather, the new owner should commit to the level of investment necessary to produce a modernized network with state of the art services delivered to the ratepayers. If the new owner has a better proposal that costs significantly less than $100 million, then the ratepayers and the owners may both benefit from a smaller investment. The key here is that a new network will be delivered to the ratepayers.[28] The new owner may have

[28] The Company and Technical Consultants have made independent assessments of the condition of VITELCO's plant infrastructure and both concluded that it is badly in need of replacement or upgrade. Outside plant is dilapidated. (Cite) Wires remain on poles abandoned by the power company, are strung through trees, or lay on the ground. Cables are undersized, and often used for unintended purposes (i.e., of the wrong size and type) and have been neglected to the point that normal rain causes significant network outages. VITELCO's witness Keith Milner described only 3 out of 29 substations as rising even to the level of "fair" condition, with all other substations failing. Cross connections are corroded and terminal boxes and pedestals are open to the elements. Switching equipment is outdated and switch software is no longer supported by the manufacturers. Buildings have been compromised by water intrusion and are in need of serious repairs. Support systems needed to manage the network or to provide adequate customer services are well below industry norms or are nonexistent. While both parties agree on the condition of the network, they disagree on how the issue should be handled in the transfer of control proceeding. The Technical Consultants recommend that the buyer must commit to an average investment of about $20 million per year for the next five years. The Company argues that a fixed requirement for $100 million investment over five years increases regulatory risk, resulting in either no bid or a reduced bid. Further, there are many possible technological and network design issues that come into play and which could change the amount of network investment needed. For example, the buyer may implement a packet switching technology in place of the current circuit switching technology, or it may use wireless connections in place of wire or fiber. The Company sees the Technical Consultants' proposal as unduly restrictive and as binding the hands of the buyer in making technological choices. The Company's strongest objection, however, seems to be the fixed amount of investment. Instead, it would leave this decision to the buyer. There is substantial support in the record for a commitment of $17-20 million per year over a five year period. PSC Technical Consultant Deuchler testified that he was told by Mr. Garnett, interim VITELCO CEO, that a significant investment would be needed to improve the network and rectify known deficiencies. Mr. Garnett said the same thing when he appeared before the Commission in connection with the request for approval of the Stipulated Judgment filed in the US District Court, Southern District of New York on December 13, 2007.

several sources for the investment dollars, including current income,[29] potential tax subsidies, and a restitution claim for allegedly inappropriate diversion of VITELCO's funds by former management.

5. The buyer should be ready to discuss what type of long term commitment it will make to the community in exchange for the regulatory benefits that flow from this transaction. It would be helpful if the new owner agreed to retain ownership of VITELCO's regulated operations for a period of at least five years and may not transfer or sell any portion of the local exchange network during that period. However, this commitment could be excused if the new company installs state of art facilities and services. Once the new company performs it is not necessary that a further sale of the company be hampered. Because of the extraordinarily poor condition of the current infra-structure and services it may be reasonable to discuss time commitments which can be eliminated once the new services are delivered.
6. The buyer must agree to meet the quality of service standards established by the Commission. The new owner should be required to restore the system in an expedited fashion. The capital plan should be evaluated on the availability of resources and requirements of the system.

Technical Consultant Deuchler arrived at his figures by adjusting the average investment per line on the US mainland for the increased cost of constructing and operating customer lines in the Virgin Islands.

[29] VITELCO currently generates cash flow from depreciation of approximately $20 million per year. This amount was adjusted downward by $5 million by Technical Consultants and included in their revenue requirement recommendation. Nevertheless, much, if not all, of the capital required for replacement or improvement of the network can be covered using internally generated funds. Finally, we note that depreciation has been and continues to rapidly outstrip reinvestment, so that the Company's ratebase has been and continues diminishing.

7. Prudent investments should be eligible for rate base treatment. Capital expenditures of less than annual depreciation will result in a continuing declining rate base and will result in declining rates and revenues in the near future.
8. The buyer must agree to reasonable safeguards for employees given the fact that it is the employees who, according to President Garnett have kept telephone services alive in the Virgin Islands and the fact that that their financial future has been severely compromised by former management in that there is a $20 million pension funding obligation that has not be met.
9. The buyer must agree that it will be subject to regulation and all applicable outstanding orders of the Commission and must agree to pay its regulatory assessments.

The Company's witnesses generally agree that the new owner should be financially viable, should have a strong and experienced management team and should commit to providing high quality service. These recommendations are not onerous and are typical of transfer of control proceedings in other jurisdictions and prior transfers within this jurisdiction.

XIII CONCLUSION

VITELCO's ratebase is $60,235,716.00 and declining at a troubling rate. In order to turn its operation around it must invest in a new telecommunications network system because it has neglected its network since the 1980s. Accordingly, the ratepayers endure sub-standard service and have not been treated equitably by the telephone company. There is no doubt that the estimated current cost of capital is in excess of 11.5%, VITELCO's current authorized rate of return. An analysis of VITELCO's financial records establish that based on the discussion, infra, VITELCO is earning a 9.28% rate of return. Based on the U.S. Supreme Court standard set forth in *Bluefield Water Works & Improvement Company v. Public Services Commission of West Virginia,* 262 U.S. 679 (1923); and *Federal Power Commission v. Hope Natural Gas Co.,*320 U.S. 591 (1944), the PSC cannot set the allowable rate of return lower than 11.5%. We further find that even if the PSC Technical Consultants' position on the cost of capital was adopted by this tribunal, their estimated cost of capital (9.42%) is greater than the 9.28% VITELCO is currently earning and hence, rates would not be affected. Rates are not the issue. The lack of adequate service, however, is and this issue must be revisited in the subsequent change of control proceedings.

Based on the foregoing regarding VITELCO's rate base and operating expenses, as indicated above, we find that VITELCO's current rates generate a rate of return of 9.28%. This rate of return is below the Company's currently authorized rate of return of 11.5% and is less than VITELCO's current cost of capital, which we find to be in excess of 11.5%. Under the circumstances, we find no basis to conclude that VITELCO is overearning and thus do not accept the Commission's Technical Consultant's recommendation that VITELCO's current rates be reduced.

However, these findings should not be construed as authorization for VITELCO to increase rates after this proceeding has concluded, as the Company apparently did at the close of Docket #532. The determinations by the Hearing Examiner concerning VITELCO's cost of capital are complicated by the Company's financial situation and the current sale process. After that sale process has concluded, the Commission will be able to determine more precisely

VITELCO's cost of capital, since it will know the new company's capital structure and cost of debt -- information that is not available to the Hearing Examiner. Should VITELCO seek to increase rates before the next earnings investigation, the Commission should carefully scrutinize any proposed rate increase and ensure that any new rates: (i) do not result in VITELCO earning in excess of its cost of capital; (ii) reflect new depreciation rates consistent with this Recommended Order; and (iii) are commensurate with the quality of service being provided by VITELCO.

The present rate review is handicapped by the pending sale of VITELCO, the bankruptcy of its parent entities, lack of planning and investment by the prior management, and the uncertainty surrounding the future capital structure of the corporation. PSC Technical Consultants said that any new owner should have a clear understanding of expectations of the Commission's regulatory requirements in order to insure that customers will receive high quality service in the future. We agree that such guidance is essential so the bidders will know the full scope of the potential obligations of ownership of VITELCO and observe that such a clear statement would also be helpful to the Bankruptcy Court in reviewing proposals and selecting and approving the bid that will most likely result in a successful resolution of all outstanding issues. We are also sensitive to the fact that if the PSC were to impose too many requirements new potential owners might conclude that they are entering a hostile regulatory environment with a degree of micro-management that is not attractive. This impression would be wrong, however. The Commission has always been reasonable with this utility and has no interest in creating the expensive infra-structure necessary to micro-manage VITELCO. The Commission simply wants to see a responsible telephone company committed to delivering quality services to Virgin Islanders and potential bidders should not conclude that they are entering hostile regulatory waters.

As the Commission and the public reviews this Opinion, it is obvious that the Hearing Examiner has limited options available due to the fact that prior management put everyone in a very difficult position. The network has been neglected and service is inadequate. Yet we were constrained not to create conditions that would cause the bankruptcy sale to fail. Moreover, we had to fight the urge to be punitive given the history of abuse this telephone company has heaped

on its ratepayers. We were, however, urged not to dwell on the past but to create a structure that would help bring the resources necessary to create a better telecommunications future for Virgin Islanders and we have endeavored to follow that advice.

Having said that, the misappropriation of funds should be addressed in other investigations that may be ongoing. Preserving restitution as a potential asset may play a critical role in the overall analysis that a new potential owner undertakes when making a bid in the bankruptcy process. Accordingly, it is important that the entities that could fight over those claims have some immediate discussion with each other prior to the bankruptcy sale.

During the course of the hearing VITELCO offered evidence that strongly suggested that former management inappropriately diverted VITELCO's liquid assets to a variety of other sources and other locations. Based on the testimony it is extremely likely that criminal investigations are either underway or will follow the public airing of some pretty serious criminal acts.[30] Based on the testimony we have little difficulty finding from this record that the actions and conduct of the prior management (and ownership) of VITELCO clearly demonstrate violations of their respective fiduciary duties and obligations to VITELCO the company. As a result, significant funds have been misused or are unable to be adequately or accurately accounted. Under Virgin Islands law, VITELCO as a corporation has the power to be sued or to bring suit on its own behalf. It has all the powers of any "person" as is provided for under 1 V.I.C. s. 41 (stating, ""person' and 'whoever' respectively include corporations, companies, associations, joint stock companies, firms, partnerships, and societies, as well as individuals")

It is not clear from the record, what actions the Trustee or his representatives have made on behalf of VITELCO in order to ensure that the those funds taken from the company are returned or what steps have been taken to preserve those rights for the new buyer. We are aware that former management and the Board of Directors have been replaced. And we are aware that

[30] It is important to recognize that former management did not participate in this hearing and so we have only the testimony of current VITELCO management and the PSC. Accordingly, no names have been used in this opinion because those individuals were not participating and thus could not present alternate arguments to justify their actions.

the former owner of the company is currently involved in personal bankruptcy proceedings. However, it is unclear what steps have been taken to ensure if some or all of those funds that were taken from VITELCO can be returned. This question is essential in that it can have a critical impact in terms of bringing much needed funds back to the telephone company to help rebuild its neglected infrastructure. We order that the Trustee and/or his representatives meet with the Commission and/or its staff or its agents before December 19, 2008, to discuss this issue. The discussion should include a delineation of what actions have been taken by the Trustee. It is also important to ascertain prior to the completion of the sale, what steps are being taken to preserve any future claims that may be brought by the new purchaser or acquirer of the company regarding these funds.

During the proceedings PSC Counsel confirmed that there had been some prior directive given by a former PSC lawyer to both PSC and VITELCO employees that neither group should cooperate with investigations generated by the Bankruptcy proceedings. It goes without saying, that had such a directive been issued it would have been an illegal order and possibly violative of Title 18, United States Code, Section 4, entitled Misprison of a Felony. Federal law prohibits the concealment of such information by those who have evidence of felonious wrongdoing. When asked to provide such information to the appropriate investigative authorities, it must be furnished. We are hopeful that the mere mention of this will be sufficient to encourage the ratepayers, the PSC, and VITELCO to cooperate in any such investigations not only because it is the right and lawful thing to do but because it will increase the likelihood that the restitution interests of these entities will be protected and preserved.

ORDERED that this Opinion be presented to the Public Service Commission for its consideration.

Entered this 1st day of December, 2008.

David Marshall Nissman
Hearing Examiner

CERTIFICATE OF SERVICE

I hereby certify that on December 01, 2008, I electronically served the Commission staff's **"Finding of Facts"** and the **"Hearing Examiner's Memorandum Opinion and Order"** in PSC Docket 578: the rate investigation of VITELCO on the following individuals:

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I further certify that a copy of the information and certification requests have been entered into the record in this Docket.

Michael S. Moore